



2008

The SEC, Retail Investors, and the Institutionalization of the Securities Markets

Donald C. Langevoort

Georgetown University Law Center, langevdc@law.georgetown.edu

This paper can be downloaded free of charge from:
http://scholarship.law.georgetown.edu/fwps_papers/80

This open-access article is brought to you by the Georgetown Law Library. Posted with permission of the author.
Follow this and additional works at: http://scholarship.law.georgetown.edu/fwps_papers



Part of the [Economics Commons](#), and the [Securities Law Commons](#)

GEORGETOWN LAW

Faculty Working Papers



September 2008

The SEC, Retail Investors, and the Institutionalization of the Securities Markets

Donald C. Langevoort

Thomas Aquinas Reynolds Professor of Law

Georgetown Law

langevdc@law.georgetown.edu

This paper can be downloaded without charge from:

BePress: <http://lsr.nellco.org/georgetown/fwps/papers/80/>

SSRN: <http://ssrn.com/abstract=1262322>

Posted with permission of the author

THE SEC, RETAIL INVESTORS, AND THE INSTITUTIONALIZATION OF THE SECURITIES MARKETS

*Donald C. Langevoort**

The Securities and Exchange Commission thinks of itself as the investors' advocate, by which it means retail investors – individuals and households – as opposed to institutional investors. To be sure, it tries to help the latter as well. But throughout the SEC's history and culture, the rhetorical stress has been on the plight of average investors, ones lacking enough investing experience and sophistication to need the protection of the securities laws.¹ Broad popular demand for regulation in response to the appearance of scandal and economic distress brought the federal securities laws into being some seventy-five years ago.² The subsequent history of rules, interpretations and enforcement by the SEC is filled with references to the need to promote retail-level investor confidence to give depth and liquidity to the nation's financial markets, and the desire to the same end to level the playing field as between the meek and the powerful.³

The last thirty years or so have brought a rapid shift toward institutionalization in the financial markets in the U.S., i.e., investment by mutual funds, pension funds, insurance companies, bank trust departments and the like. That the market for corporate securities traded on the New York Stock Exchange or the Nasdaq Global Market is no longer substantially retail in nature is now common knowledge.⁴ Many other organized or informal markets (e.g., some of the debt markets, or

* Thomas Aquinas Reynolds Professor of Law, Georgetown University Law Center.

¹ See generally JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* (3d ed. 2003).

² As often happens, the facts underlying the perception of scandal and abuse may have been much more complicated and ambiguous. See Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 31 J. Legal Stud. 1 (2001).

³ See Donald C. Langevoort, *Rereading Cady Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 Colum. L. Rev. 1319 (1999).

⁴ See SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION FACT BOOK 2007, at 65 (institutions owned 73.4% of the market value of outstanding equity securities in 2006). One should not take from this that individual and household direct investment has declined in absolute numbers. In fact, from 1965 to 2006, the value of equity securities owned directly by households increased from approximately \$616 billion to \$5.5 trillion. *Id.*

the market for start-up venture financing) are largely institutional as well, and there are newer forms of institutional ownership – hedge funds and private equity firms in particular – that had a relatively small presence before the 1980's but now collectively invest trillions of dollars. As a result, for example, although retail investors have certainly suffered as a result of the recent sub-prime and debt market troubles, this was largely collateral damage from problems originating in the institutional world of structured finance, collateralized debt and credit derivatives.⁵

There are scores of academically interesting questions raised for securities regulation by the process of institutionalization (or “deretailization”⁶), far more than any one article could possibly address. Hence, I intend to be very selective in what follows and focus mainly on the institutional role of the SEC as a seventy-five year old agency in a capital marketplace far different from that of the 1930's. A baseline question about the future of financial regulation in the U.S. is whether the SEC, with such a long and weighty legacy of law-making from a time when public markets were retail markets, is competitively fit to act as a regulator in a capital marketplace that is now so institutional and global.

Securities regulation has two main, overlapping subject areas. One is the regulation of the securities markets and the securities industry. The other is the regulation of corporate issuers (and information about issuers) to aid investor decisions.⁷ Part I turns entirely to the first subject area and asks whether there is a coherent theory or approach to retail investor protection in today's marketplace, either in terms of enforcement intensity or rule-making. Here I consider two very different contemporary challenges to SEC's orthodoxy: the emergence of the

⁵ See Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 Minn. L. Rev. --- (forthcoming, 2008).

⁶ Readers familiar with a provocative speech by SEC General Counsel Brian Cartwright, entitled “The Future of Securities Regulation,” given at the University of Pennsylvania Law School's Institute for Law and Economics on Oct. 24, 2007 (available at www.sec.gov/news/speeches/2007/spch102407bgc.htm), will notice an overlap with some of the subjects covered in this article. “Deretailization” is Cartwright's word, which he confesses may be somewhat “ugly.” *Id.* at 2. I agree and prefer the more common “institutionalization.”

⁷ Historically, it is unclear whether this second objective was simply subsidiary to the first (i.e., that if issuers made full disclosure, markets would be less hard to manipulate) or whether Congress had a more aggressive corporate governance agenda. For a view inclined toward the latter, see Cynthia Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 Harv. L. Rev. 1197 (1999). Whatever Congress' original intent, the corporate regulation portion of the securities law has surely grown to rival market regulation.

British “light touch” to securities industry regulation, which favors informal suasion to heavy-handed enforcement, and the expansion of knowledge about consumer and investor behavior from research in behavioral economics. Neither, I argue, maps well onto the SEC’s mission. Part II then moves to the institutional marketplace for issuer securities and engages in a thought experiment about whether, as many assume, markets that have no appreciable retail participation should properly be governed as “antifraud only.” I consider what antifraud-only means, and once again express some skepticism about whether we can expect to see the development of private markets, largely free of regulation, that substitute for the public ones we observe today. Finally Part III takes up whether the SEC’s regulatory orthodoxy is stable enough as markets become not only institutional but global. I suggest, contrary to what many believe, that globalization leads to increasingly territorial (rather than listings) based exercise of regulatory jurisdiction over issuer disclosure. I place the SEC’s recent initiatives toward mutual recognition in this context.

The unifying theme here stems from my long-standing interest in studying the behavior of the SEC: why it acts as and when it does and (often more importantly) what limits it imposes on itself or has imposed from outside.⁸ Behind its public face, the SEC is a political entity, balancing its internal vision of investor protection against host of competing pressures and constraints. That should hardly be a surprise: the Commission was born as a political compromise in 1934 as part of an effort by Wall Street lobbyists to take jurisdiction over securities regulation away from the Federal Trade Commission, to whom it had been given when the first federal securities statute had been passed the year before, and give it to specialists in a new bureaucracy who might be more sympathetic to the business community.⁹ In the seventy-five years since, it has felt constant political pressure from the White House and Congress, applied through the appointments process, the agency's budget, and more indirect means of suasion such as the adverse publicity

⁸ See, e.g., Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 Wash. U. L. Rev. 1591 (2006); Langevoort, *supra*. Many others have explored these questions as well. E.g., John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost-Benefit Analysis*, 41 Va. J. Int’l L. 531 (2001); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 Cardozo L. Rev. 909 (1994); A.C. Pritchard, *The SEC at Seventy: Time for Retirement?*, 80 Notre Dame L. Rev. 1073 (2005).

⁹ See SELIGMAN, *supra*, at 95-99.

that can follow from oversight hearings and investigative reports.¹⁰ That pressure, in turn, is the product of public and private demands from a host of interests affected by the substance of securities regulation, some of which are far more organized and well financed than others. There are also resource constraints that limit what the Commission and its staff can discover, implement or enforce. Finally, there are agency costs inside the agency: commissioners and staff collectively have career interests and cognitive constraints¹¹ that influence how the SEC acts.

As a result of all these limitations, the Commission is the investor's champion only in a bounded way. Whether it serves investors reasonably well or not so much within these bounds is a matter of divisive professional and scholarly debate, but at least the limitations are visible enough to careful observers. Less so, perhaps to the general public, which creates the risk of an "expectations gap" between popular beliefs about the efficacy of the SEC and the reality of its quite limited presence. By looking closely at what motivates and constrains the SEC's behavior in today's complex and changing securities markets, we can build a better understanding of both its identity and its political ecology.

I. RETAIL INVESTOR PROTECTION IN AN INSTITUTIONALIZED MARKETPLACE

The institutionalization of the securities markets does not mean that retail investors make fewer or less important investment decisions, simply different ones. The numbers of individuals and households that invest (and the amount they invest) has grown steadily over the last decades. Increasingly, however, retail investment decisions relate to investing in a mutual fund or insurance product, making retirement plan elections or deferring to account management by a brokerage firm or investment adviser, rather than investing directly in issuers' securities.

The regulatory context here is notoriously fragmented, requiring that we be particularly selective. In the broker-dealer area, Congress chose in the mid-1930's to allow the industry to regulate itself as a first line of control, under SEC supervision.¹² Hence much of the conduct regulation here is by self-regulatory organizations (most importantly,

¹⁰ See Anne Khademian, *The Securities and Exchange Commission: A Small Regulatory Agency with a Gargantuan Challenge*, 63 Pub. Admin. Rev. 515 (2002).

¹¹ See Langevoort, *supra*; Stephen Choi & Adam Pritchard, *Behavioral Economics and the SEC*, 56 Stan. L. Rev. 1 (2003).

¹² See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 16-17, 1021-23 (5th ed. 2006).

FINRA¹³) rather than by the SEC directly. Because there are important exceptions and a substantial level of SEC oversight, there is a blurring of any clear distinction in the allocation of responsibility. In the mutual fund area, the SEC's role is more dominant, though FINRA regulates fund distribution practices as well. There is no SRO for investment advisors, but here, since 1997, there has been a division of primary supervisory responsibility between the SEC and state securities regulators based on the size of the advisor.¹⁴ In other areas, like banking, insurance and commodities products that have investment features, the SEC is either partially or entirely divested of jurisdiction, with dimly illuminated lines of divestiture here as well. As a result, even describing (much less evaluating) SEC regulation in the retail sector is both complicated and context-specific.

In the face of this complexity, the overriding question is how well the SEC does at making the securities industry behave appropriately with respect to retail investors. When posed at that level of generality (which ignores the immense diversity in types of industry-investor transactions), it forces us to confront serious gaps in our knowledge. Three questions loom. First, what do we even mean by industry misbehavior?¹⁵ It is not clear that we have a good sense of when a broker or advisor crosses the line, short of abject fraud. Second, how much misbehavior is there in the industry? We can count investor lawsuits and complaints with regulators, but this would not necessarily capture the full extent of problems – many forms of opportunism are difficult even for victims to detect, for a variety of practical and cognitive reasons, and even if investors discover some evidence of abuse, they will not always take action. Conversely, not all suits and complaints have merit. Third, what is the causal relationship between regulatory enforcement and good or bad behavior? There are competitive and reputational constraints on misbehavior, so that it is hard to know how tightly coupled regulatory threats and industry behavior really are regardless of intensity.

¹³ The Financial Industry Regulatory Authority (see www.finra.org.) FINRA's predecessor was the National Association of Securities Dealers (NASD), which in 2007 merged with the SRO arm of the New York Stock Exchange.

¹⁴ See JAMES D. COX ET AL., at 1081-82.

¹⁵ Because of the complexity in typology just described, even what we mean by "behaving well" varies – for example, investment advisors (including advisors to mutual funds) are fiduciaries while brokers usually are not. *Id.* at 1084-88. But brokers are subject to a variety of obligations that insist on living up to "just and equitable" or "fair dealing" principles, which may not be all that far from fiduciary status as applied to concrete situations. *Id.* at 1032-35.

This profound ambiguity means that perceptions of industry abuse are socially constructed, and will vary over time.¹⁶ The demand for regulation in this area will spike periodically as large scandals appear, and the SEC will respond based on meager base-rate evidence.¹⁷

A. Intense Enforcement versus the “Light Touch”

Perhaps because it is driven by socially constructed responses to periodic scandal, SEC regulation of the securities industry is often described as heavy-handed, overly intrusive and enforcement dominated.¹⁸ Recent calls for reform of securities regulation in the U.S. have targeted this, raising doubts about cost-effectiveness and whether it unduly burdens global competitiveness. The usual point of comparison is the United Kingdom, where the Financial Services Authority (FSA) is said to regulate very successfully with a “light touch.”¹⁹ Thus the SEC should learn from it and behave similarly.

Light-touch is a term of art to describe an approach that relies more on prudential dialog with the regulated community than ex post enforcement, and more on principles than rules. Academically, it can be linked to so-called “new governance” strategies for regulation that seek to enlist the cooperation of that community so as to overcome the inevitable informational disadvantage that regulators have when dealing with fast-changing markets.²⁰ The basic idea is to let regulated entities experiment with compliance practices without a one-size-fits-all

¹⁶ See Stuart Banner, *What Causes New Securities Regulation?*, 300 *Years of Evidence*, 75 Wash. U.L.Q. 849 (1997).

¹⁷ See Gregory Mitchell, *Case Studies, Counterfactuals and Causal Explanations*, 152 U. Pa. L. Rev. 1517 (2004); Choi & Pritchard, *supra*.

¹⁸ “Enforcement intensity” in securities regulation has received a great deal of attention as a matter of comparative law. See Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 Yale. J. Reg. 253 (2007); HOWELL E. JACKSON & MARK J. ROE, PUBLIC AND PRIVATE ENFORCEMENT OF SECURITIES LAWS: RESOURCE-BASED EVIDENCE, available at www.ssrn.com/abstract=1000086 (June 2008). Most of this attention focuses on issuer disclosure and market abuse issues. For a cogent argument in favor of strong enforcement intensity in corporate issuer regulation as compared to the U.K. approach, see John C. Coffee, *Law and the Market: The Impact of Enforcement*, 156 U. Pa. L. Rev. 229 (2007). In response, see EILIS FERRAN, CAPITAL MARKET COMPETITIVENESS AND ENFORCEMENT (April 2008), available at www.ssrn.com/abstract=1127245.

¹⁹ For a history of the FSA, see Eilis Ferran, *Examining the United Kingdom’s Experience in Adopting the Single Financial Regulator Model*, 28 Brooklyn J. Int’l L. 257 (2003).

²⁰ See Cristie L. Ford, *New Governance, Compliance and Principles-based Securities Regulation*, 45 Am. Bus. L.J. 1 (2008).

command, so long as outcomes satisfy the articulated principles. Shortcomings are remediated, but not necessarily punished. The FSA touts this as a substantial competitive advantage over the way the SEC operates.

There are important empirical questions here, including whether the systems in operation are really as different as publicly touted and whether the FSA's touch may be heavier in some areas than in others, such as customer protection as opposed to back-office regulation or safety and solvency. On its face, however, U.K. regulation of the retail securities industry does appear consistent with the light-touch philosophy, as illustrated by the FSA's new principles-based "Treat Customers Fairly" (TCF) program.²¹ For now, let's simply assume both that there is a clear distinction and that the light-touch approach has thus far worked well in the U.K. The important questions would be why, and whether the advantage could be transplantable back to the U.S.²²

Conventional economic analysis of the issue starts by assuming that the securities industry and its members are wealth maximizing and opportunistic; that opportunism is constrained, however, by a mix of legal and non-legal incentives (e.g., reputation, as noted earlier). In turn, the regulator's legal strategy can be a mix of enforcement sanctions and less formal efforts at suasion. That mix aims at optimal deterrence, i.e., the right balance probability of detection and amount of sanction in light of the expected benefits of cheating.

A low intensity enforcement strategy works if, but only if, either (a) the non-legal sanctions are already compelling enough that little regulation is necessary in any event, or (b) the informal suasion is potent enough to make subsequent enforcement unnecessary. There are a number of conditions under which this would be so with respect to the retail securities industry. One would be where the reputational harm from cheating that is detected is higher because those in the industry are culturally more sensitive to criticism – i.e., there is a strong professional norm of appropriate behavior. Another would be where the reputational sanctions on transgressions imposed by investors are more severe

²¹ See FINANCIAL SERVICES AUTHORITY 2006/07 ANNUAL REPORT, at 28, available at www.fsa.gov.uk. For a discussion, see Julia Black et al., *Making a Success of Principles-based Regulation*, Law & Fin. Mkts. Reg., May 2007, at 192-93. A recent regulatory reform effort in British Columbia invoked the U.K. approach in devising its retail broker regulatory regime. See Ford, *supra*, at 11-26.

²² A substantial body of scholarship casts doubt on how well one legal regime can be transplanted to another one with differing background norms and institutions. See Daniel Berkowitz et al., *The Transplant Effect*, 51 Am. J. Comp.L. 163 (2002).

because they generate greater fear or anger.²³ A third condition where low enforcement would succeed would be where surveillance and monitoring are sufficiently thorough that informal suasion is all that is necessary to deter.

The important thing to note is how dependent these conditions are likely to be on both the scope and stage of development of the retail investment industry. Imagine an industry that is both fairly concentrated and operates on a relatively small scale. A regulator can exercise substantial informal power relatively easily by being geographically and socially proximate to the regulated community and holding leaders reputationally “hostage” to good behavior – willing to criticize them and their firms for shortcomings.²⁴ To the extent that there are greater social network affinities between the regulator and the regulated, informal suasion is more potent.

These reputational effects will have greater bite with respect to an industry that is seeking to grow out of its infancy.²⁵ Behavioral economics (and common observation) teaches that gaining new customers is harder than retaining existing ones, even though neither is necessarily simple.²⁶ Reputational harm makes it particularly hard to convince those used to acting in a different way to abandon the status quo. By hypothesis, those in a growing industry should be more sensitive to the risk of informal sanctions such as bad publicity than a mature one.

These two points might help explain the success of a light-touch approach to retail investor services regulation in the U.K. The retail industry there is small but growing,²⁷ and still relatively concentrated.

²³ Along these lines, we could ask whether British stockbrokers might be culturally more sensitive to charges of cheating than Americans. Questions like these receive scholarly attention, but I am not aware of much of a basis for assuming a significant difference between the U.K. and the U.S. along this dimension. E.g., Amir Licht, *Legal Plug-ins: Cultural Distance, Cross-Listing and Corporate Governance Reform*, 22 Berkeley J. Int'l L. 195 (2004).

²⁴ FSA regulation very deliberately uses top management accountability for leverage. See Black et al., *supra*, at 193. This could mean sanctioning managers, but it appears that the stress is on more informal suasion.

²⁵ Interesting along these lines is evidence of the power of “shaming” sanctions in Chinese securities regulation – surely an example of an industry trying to take hold in a society without investment experience. See Benjamin Liebman & Curtis Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 Colum. L. Rev. 929 (2008).

²⁶ The classic account here is William Samuelson & Richard Zeckhauser, *The Status Quo Bias in Decision Making*, 1 J. Risk & Uncert. 7 (1988).

²⁷ For a thorough assessment of the status of retail investor participation in the EU and proposals for promoting a stronger equity culture, with specific attention to the U.K.,

The FSA regulates approximately 1000 firms that deal or advise in securities, with slightly more than 8000 individuals authorized to conduct customer trading in securities in early 2005.²⁸ As John Armour and David Skeel point out in their study of comparative takeover regulation, the British regulatory and financial services communities have considerable social overlap, which allows informal pressure to be used more effectively.²⁹ And as the retail segment seeks to grow in Europe in the face of engrained popular habits of conservative (and governmentally-sponsored) savings, broad public perceptions that there is substantial risk to trusting retail service providers would be particularly debilitating. Regulators thus have greater leverage; their quiet threats should be more potent.

By contrast, the U.S. differs massively on nearly all these dimensions.³⁰ First, the size and scope of the retail securities industry is much larger. In 2006, there were more than 5000 firms that were members of the NASD (now FINRA), with some 658,000 registered representatives.³¹ Public customers had some 111 million accounts at registered securities firms.³² And that is simply the broker-dealer industry. There are also around 10,000 investment advisory firms registered with the SEC, whose work often blurs with that of broker-dealers.³³

see Niamh Moloney, *Building a Retail Investment Culture Through Law: The 2004 Markets in Financial Instruments Directive*, 6 Eur. Bus. Org. L. Rev. 341 (2005).

²⁸ See INTERNATIONAL FINANCIAL SERVICES, SECURITIES DEALING: CITY BUSINESS SERIES, May 2007, at 14-15, available at www.ifsl.org.uk. 2006 operating profits of U.K. securities dealers (which includes activities well beyond retail) was 3.4 billion pounds. *Id.* at 15.

²⁹ See John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 Geo. L.J. 1727, 1771-72 (2007).

³⁰ In terms of total stock market capitalization, the U.S. is roughly seven times larger. Regulator expenditures for securities regulation for the two countries is not terribly different when adjusted per dollar of market capitalization; indeed, the U.K. spends a bit more. See Jackson, *supra*, at 272-73. However, total market capitalization is a poor proxy for the scale or scope of regulation, as illustrated by the figures in the text.

³¹ See SIFMA, *supra*, at 29. The pre-tax profitability of this sector was roughly \$33 billion. *Id.* at 27.

³² *Id.* at 66.

³³ See RAND CORP. INSTITUTE FOR CIVIL JUSTICE, REPORT TO SEC ON INVESTOR AND INDUSTRY PERSPECTIVES ON BROKER-DEALERS AND INVESTMENT ADVISERS, Jan. 2008, at 24, available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf. There is some overlap between the number of registered broker-dealers and investment advisers, but it is not extensive.

Because of this size and dispersion, there is likely a far greater degree substantial cultural separation and distance between the business and governmental communities. Research indicates that more closely inter-connected social networks generate mimetic behavior. Tighter networks facilitate the transmission of both ideas and norms.³⁴ In turn, social networks correlate with geographic proximity.³⁵ Building on this, for example, researchers have produced intriguing evidence that greater geographic distance between a particular firm and the SEC means less compliance with regulatory demands.³⁶ Washington and New York are culturally distinct even though closely tied, and retail securities industry leaders are based in cities far from either one. Though leaders do have dominating market share, it is far from concentrated: retail financial service providers include thousands of independent brokers and investment advisers located in every sizable town and city. In the U.S., it appears, regulators and business people share relatively little social or geographic space. Quiet suasion is less likely to be heard.

Moreover, the retail investment market is relatively mature in the U.S., with well-engrained habits by retail investors that by now are harder to dislodge. There is a multiplier effect here: the size and penetration of the retail securities industry brings with it attention by the financial and general media that supports a culture of investing. In all likelihood, the level of scandal that it would take to trigger large-scale, permanent defection by retail customers from investing in securities generally would be immense and beyond any recent experience. As a result, collective industry sensitivity to criticism (and perhaps even individual firm level sensitivity) is probably lower than it would be if the

³⁴ For a literature review relating this to finance, see David Hirshleifer & Siew Hong Teoh, *Thought and Behavior in Capital Markets*, in HANDBOOK OF FINANCIAL MARKETS: DYNAMICS AND EVOLUTION (Hens & Schenk-Hoppe, eds., forthcoming). On options backdating, see JOHN M. BIZJAK ET AL., OPTIONS BACKDATING AND BOARD INTERLOCK (Feb. 2007), available at www.ssrn.com/abstract=946787. A classic article on how poison pills spread through interlocks among directors is Gerald Davis, *Agents Without Principles? The Diffusion of Poison Pills Through the Intercorporate Network*, 36 Admin. Sci. Q. 583 (1991).

³⁵ There is a large literature in economics on this. See, e.g., David Audretsch & Erik Feldman, *R&D Spillovers and the Geography of Innovation and Production*, 86 Am. Econ. Rev. 630 (1996).

³⁶ See MARK L. DEFOND ET AL., THE GEOGRAPHY OF AUDITOR INDEPENDENCE AND SEC ENFORCEMENT, available at www.ssrn.com/abstract=1132885 (May 13, 2008)(measured by distance from SEC regional offices); SIVI KEDIA & SHIVARAM RAJGOPAL, GEOGRAPHY AND THE INCIDENCE OF FINANCIAL MISREPORTING (2008), available at www.ssrn.com/abstract=1121453.

retail industry were at an earlier stage of marketplace development, where there was no pattern of customer loyalty.³⁷

What all this suggests, then, is that differing economic and regulatory conditions themselves might explain the relative success of a light touch in the U.K. in a way that could not be transplanted to the U.S.³⁸ If so, the critics' call for SEC to follow the FSA here and simply lighten up is misplaced. Moreover, any competitive advantage the U.K. currently has is itself contingent and subject to erosion. If the U.K. retail investment market grows and matures, becoming more diffuse and complex, the potency of the FSA's non-enforcement tools are likely to weaken and the conditions it faces will start to resemble those the SEC has faced for many decades now.

This account leads to an obvious political difference as well. In the U.K., the current retail investor base is small and thus retail investor protection issues have less political saliency. Media attention to these issues is presumably less as compared to other retail financial services areas (banking, insurance) and large-scale institutional investor issues (pension and retirement plans, etc.). Therefore, the FSA can afford to pay less attention to this segment in favor of work for which there is stronger demand. Light-touch regulation presumably works better in institutional markets anyway – an issue we take up in Part II – because of the greater capacity for investor self-help, and so the FSA's natural regulatory inclination meshes with lower political demand to produce a comfortably low level of regulatory intensity in the retail area as well.³⁹

Furthermore, to the extent that the government wants to encourage growth in the retail sector, it may be inclined to keep the

³⁷ A good example of this is the mutual fund industry. Examples of abuse by some advisory firms led to a near-term loss of business for those firms. See Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. Rev. --- (forthcoming 2008). However, notwithstanding indications that the temptations and opportunities for similar abuse are industry-wide, there has been no broad-based loss of retail investor business.

³⁸ Of course, there are many other potential differences. For instance, the intensity of competition in the industry will likely affect the rate of cheating. Also, there may be differences in how strongly the judicial system either supports or limits regulators' enforcement efforts – judicial protection of business "rights" as against administrative control gives the industry more leverage to negotiate with the regulator.

³⁹ See JOHN ARMOUR, ENFORCEMENT STRATEGIES IN UK CORPORATE GOVERNANCE: A ROADMAP AND EMPIRICAL ASSESSMENT (April 2008), available at www.ssrn.com/abstract=1133542. Consistent with the social networks approach, Armour suggests that as the U.K. attracts more foreign institutional investors to its markets, the informal suasion network will be strained and more conventional enforcement techniques used. Id. at V:9-10.

regulatory process quiet and informal so as not to damage that growth through publicity that unduly alarms potential investors – a strategy that could pay off when opportunism is hard to detect and alternative means of exposure (media, plaintiffs’ lawyers, etc.) are less likely. An important cultural difference between the SEC and the FSA is that the latter was born out of a decade-long effort by the U.K. to gain a comparative advantage in financial services. Regulation and the promotion of economic and industry growth are seen as connected, and the effort has generated positive feedback: the U.K. is now a world leader in many segments of global finance. Once again, however, this is contingent. Any significant growth in the British retail sector would over time change the political equilibrium to more resemble that found in the U.S so that the stresses of investor losses and the scent of scandal will weigh more heavily.

My argument here is not that the SEC’s (or U.S.’s) greater enforcement emphasis is better, much less optimal – simply that the two systems have fundamental differences in susceptibility to styles of regulation. Quite likely, the SEC has much to learn from new governance and “responsive regulation” ideas that seek greater industry openness and cooperation and encourage experimentalism in best practices.⁴⁰ Ultimately, however, the informational asymmetry between the regulators and the regulated – mainly the result of an immense atomization of the firms’ selling efforts in millions of privacy-protected customer accounts – is such that the industry can pretend cooperation and conceal opportunism long enough to generate considerable profits when retail investor sentiment is high. Deference to experimentalism works only when there is a credible threat that bad faith will be discovered and punished.⁴¹ In many ways, the system of self-regulation implemented in the U.S. in the 1930’s was a new governance experiment, giving the industry a large degree of deference so long as it committed to the very open-ended principles set forth in the statute. Though no doubt a successful experiment to some extent, self-regulation has also concealed a substantial level of abuse. As a result, there has been a gradual renegotiation to make self-regulation both more bureaucratized and more independent of the industry.⁴² The effect this

⁴⁰ See Ford, *supra*.

⁴¹ *Id.* at 32-33

⁴² See Joel Seligman, *Cautious Evolution or Perennial Irresolution? Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 *Bus. Law.* 1347 (2004).

has had on making the industry more transparent or cooperative is unclear, but it was a reaction to repeated opportunism.

Nor am I suggesting that enforcement intensity in by the SEC and its self-regulatory affiliates consistently hits its mark. We come back to the base-rate problem. For all the sanctions imposed against members of the securities industry, we still have no idea how much unlawful opportunism there is or how much profit it generates either for firms or their agents. It is possible (though not self-evident) that even with the occasional mega-cases – e.g., the \$1.4 billion global settlement growing out of allegations of analyst conflicts of interest⁴³ – and thousands of smaller enforcement cases and arbitral awards, the probability of detection and size of sanction is extremely small by contrast to the profits from hard-wired industry aggressiveness. If so, then the optimal industry-wide strategy remains opportunism with guile, worrying at most about the small risk of individual criminal prosecutions for the worst of behaviors but otherwise treating occasional liability as a cost of doing business. This is a familiar enough concern. One of the darker possible portrayals of the SEC is that it takes mainly symbolic, dramatic enforcement action that, when measured against the massive size and scope of the securities industry, merely creates the illusion of thorough policing. The dramaturgy satisfies the public’s demand for a champion, produces occasional recoveries that can visibly be distributed to investors in the form of “fair funds,”⁴⁴ and blunts calls for any more intrusive regulation. The SEC becomes an enabler, either innocently (cognitive blindness to its own limitations) or deliberately (agency capture).⁴⁵

I am inclined to resist this darker rendering, but there is too big a knowledge gap to be entirely sure. The repetition of securities industry scandals every few years – analyst conflicts, mutual fund late timing, credit ratings and sub-prime sales tactics just in the last decade – is cause for concern that the deterrence calculus is systematically too low, as industry critics insistently contend. If so, however, it would simply lead to the conclusion that more SEC resources and enforcement intensity is the cure, not less – hardly anything that points toward light-touch as a

⁴³ See Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. Rev. 39, 42-43 (2007)(describing settlement).

⁴⁴ For a discussion of various mechanisms for compensating victims of securities fraud, see Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. Corp. L. 223 (2007)

⁴⁵ A variation on this is that the SEC regulates only after market downturns, when investors are cautious anyway, rather than during upsurges when protection is needed. See Amatai Aviram, *Counter-Cyclical Enforcement of Corporate Law*, 25 Yale J. Reg. 1 (2008).

comparative advantage. Of course, there is the contrary possibility is that public demand for regulation in the face of adverse publicity is excessive, so that dramaturgic enforcement efficiently blunts that demand at relatively low cost.⁴⁶ For this to be so, however, we have to assume that reputation and other non-legal checks on industry opportunism are very strong and that so-called scandals are either just occasional outliers (occasional “bad apples”) or the product of public, political or journalistic misunderstanding. These arguments, too, are familiar enough.⁴⁷

Lacking more data, we can only seek to estimate the level of opportunism in the retail securities industry, and hence the optimal level of responsive enforcement, through some combination of theory and circumstantial evidence. In the section that follows, I will turn to current research in behavioral economics for some more insight. As to marketplace checks, this is not the place for an exhaustive analysis of either reputational or competitive constraints on opportunism. Like most everything in the securities industry, these are highly contingent. When products and marketing are standardized, the presence of diligent investors will make it harder to take advantage of less diligent ones, but when either products or their marketing can be differentiated among categories of investors – classes of mutual fund shares with different cost structures, for example – this check weakens.⁴⁸ To say any more than this requires specification of what products, what customers, and how the sales interaction occurs. For now, I suspect the better argument is that agency problems in the retail securities industry are fairly severe, and that a lighter touch to regulatory enforcement, in the British style, would be a poor fit given the nature, size and scope of the industry as it exists today in the U.S.

⁴⁶ For a discussion of the value of investors’ emotional demands, see Peter Huang, *Regulating Irrational Exuberance and Anxiety in the Securities Markets*, in *THE LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR* 501 (Francesco Parisi & Vernon Smith, eds., 2005).

⁴⁷ There is also the possibility that less threat actually leads spontaneously to greater law-abidingness. There is some interesting social science literature that in settings of low probability of detection, a little enforcement may be worse than no enforcement at all, but even if plausible in other settings, I doubt that it would apply well to a highly competitive industry like retail securities.

⁴⁸ See, e.g., Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 *J. Econ. Perspectives* 161, 168-69 (2004).

B. Behavioral Economics, Opportunism and the Centrality of Salesmanship

The foregoing leaves open an important question – precisely what is it that the SEC wants to accomplish in the name of retail investor protection? We cannot make an evaluation of either enforcement intensity in this area or marketplace checks without better defining the problem to be solved.

The principles applied to the securities industry are easy enough to articulate in the abstract: fair dealing, just and equitable conduct, full disclosure. But each of these is capacious enough to have many possible meanings in context, and invite differing possible levels of intervention by the SEC and FINRA. My aim in this section is to draw from the contemporary social science research on investor behavior to shed greater light on the regulatory task.⁴⁹ This research goes under the general headings of behavioral economics or behavioral finance.⁵⁰ These disciplines are often portrayed as a rebuttal to neoclassical economics, which has long offered strong, testable predictions about human behavior based on simplifying assumptions of rationality and utility maximization. Under neoclassical theory, rational actors weigh all available information in a Bayesian search process; in economic exchange transactions, for example, buyers recognize and price the risk that comes from incomplete information, creating an incentive for sellers to volunteer (and vouch the accuracy of) information in their possession where such disclosure would lower the compensation buyer demand because of that risk. As noted earlier, competition among sellers can deter opportunism. By hypothesis, there would be little need for legal protection beyond vigorous contract enforcement and the law of fraud.

⁴⁹ For an earlier effort in this direction, see Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and their “Sophisticated” Customers*, 84 Cal. L. Rev. 627 (1996). Behavioral economics has received increasing attention in securities regulation in the last decade, though more with respect to regulation of issuer disclosure than industry regulation. E.g., Troy Paredes, *Blinded by the Light: Information Overload and the Consequences for Securities Regulation*, 81 Wash. U.L.Q. 417 (2003).

⁵⁰ For a survey of the voluminous behavioral finance literature, see David Hirshleifer, *Investor Psychology and Asset Prices*, 56 J. Fin. 1533 (2001). It is important to distinguish between market and individualized investment settings. As to the latter, behavioral insights are clearly important and compelling; in the former, the conventional argument is that psychological biases are washed out by marketplace arbitrage. Behavioral finance is mainly concerned with the degree to which this is in fact true. In this section, I am not addressing such marketplace issues.

The SEC implicitly rejects this classical economic argument based on the assumption that while some number of investors might conform to its predictions, others – naïve, unsophisticated – need greater protection. Remarkably, however, the Commission has never studied retail investor behavior enough to be able either to predict, even roughly, the relative frequency as between the rational and the naïve or to describe an alternative decision-making process that unsophisticated investors employ. Its habitual use of the disclosure remedy in retail investor protection, for instance, rests on the unexamined (and often dubious) premise that investors who fall short of the rational actor model enough to require paternalistic intervention will necessarily process the information rationally once it is delivered to them.

Behavioral economics studies human behavior in an effort to find regularities in judgment and choice in economic settings. The literature is now filled with evidence of so-called heuristics and biases, i.e., systematic departures from Bayesian rationality. Unfortunately from a theoretical perspective, heuristics and biases are not so natural or automatic that all people can be said to exhibit them in all circumstances. They are simply ways of thinking that appear in laboratory experiments and field studies with statistically significant frequency. As applied to investor decision-making, this limitation led early on to doubts that the laboratory findings necessarily tracked behavior by people in real-life financial market settings characterized by high stakes, the opportunity to learn from experience and the like.⁵¹ But substantial progress has occurred. There is a growing literature in experimental behavioral economics to test predictions of investor behavior using subjects whose background and experience offer reasonable proxies for particular kinds of investors (e.g., MBA students as proxies for relatively sophisticated

⁵¹ See Richard A. Posner, *Rational Choice, Behavioral Economics and the Law*, 50 *Stan. L. Rev.* 1551 (1998); see also Richard Epstein, *Behavioral Economics: Human Errors and Market Corrections*, 73 *U. Chi. L. Rev.* 111 (2006). Interestingly, Judge Posner recently posted on his web site an assessment of the recent sub-prime debacle that says that “studies in cognitive and social psychology have identified deep causes for he overoptimism, wishful thinking, herd behavior, short memory, complacency and naïve extrapolation that generate speculative bubbles – and that require heavy doses of reality to hold in check.” See *Against Bailouts*, Aug. 19, 2007, available at www.becker-posner-blog.com/archives/2007/08/against_bailout.html. Even though his point was against paternalistic intervention, his concession to the power of psychology in markets prompted a critical response from his co-blogger, Gary Becker. For a good discussion of the power and limitations of laboratory studies, see Steven Levitt & John A. List, *What Do Laboratory Experiments Measuring Social Preferences Tell Us About the Real World?*, 21 *J. Econ. Perspectives* (2007).

investors⁵²). Outside the laboratory, large data sets have been collected to examine the actual behaviors of retail investors – e.g., one of on-line customers of a major U.S. brokerage firm,⁵³ and another dealing with Finnish investor activity⁵⁴ – in order to test decision-making in real life.⁵⁵ In the mutual fund area, a great deal of data regarding fund flows permits behavioral predictions to be tested as well.⁵⁶

As a general matter, these studies amply support the idea that investors act in a less than fully rational way with enough frequency to be concerned. But base-rates remain a problem: how often and to what degree is highly situational. That the problem may be large is bolstered by an observation that economists (including the most orthodox) have known for some time: that investors, on average, pay far too much for investment advice and assistance. In his well-publicized Presidential Address to the American Finance Association, Kenneth French has estimated the capitalized amount spent on investment advice (retail and

⁵² E.g., Don Moore et al., *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 *Org. Behavior & Human Dec. Processes* 95 (1997). For a discussion of the extensive experimental literature on asset “bubbles”, see Erik F. Gerding, *Laws Against Bubbles: An Experimental Asset Market Approach to Analyzing Financial Regulation*, 2007 *Wisc. L. Rev.* 977 (2007).

⁵³ See, e.g., Brad M. Barber & Terrance Odean, *Trading is Hazardous to Your Wealth: Common Stock Investment Performance of Individual Investors*, 55 *J. Fin.* 773 (2000).

⁵⁴ Mark Grinblatt & Matti Keloharju, *The Investment Behavior and Performance of Various Investor Types: A Study of Finland’s Unique Data Set*, 55 *J. Fin. Econ.* 43 (2000).

⁵⁵ A good overview of field study research in behavioral economics is STEFANO DELLA VIGNA, *PSYCHOLOGY AND ECONOMICS: EVIDENCE FROM THE FIELD*, NBER Working Paper 13420 (Sept. 2007), available at www.nber.org/papers/w13420. In a particularly noteworthy field study, a South African financial services firm did a large controlled experiment in which it offered its loans to a large number of potential buyers, with random assignment of both loan rates and various marketing effects. As a result, by seeing who actually took up the loans at different rates, the firm could assess the value of the marketing. The result was stunning: certain simple psychological manipulations had the same effects as half a percentage point of interest rate. See MARIANNE BERTRAND ET AL., *WHAT’S PSYCHOLOGY WORTH? A FIELD EXPERIMENT IN THE CONSUMER CREDIT MARKET* (July 2005), available at www.ssrn.com/abstract=770389. Similar labeling effects have been found in securities, such as the impact of nothing more than a name change on either mutual fund flows or stock prices. See Michael Cooper et al., *Changing Names with Style: Mutual Fund Name Changes and their Effects on Fund Flows*, 60 *J. Fin.* 2825 (2005).

⁵⁶ See, e.g., Edwin Elton et al., *Are Investors Rational? Choices Among Index Funds*, 59 *J. Fin.* 261 (2004); Andrea Frazzini & Owen Lamont, *Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns*, 88 *J. Fin. Econ.* 299 (2008).

institutional) as at least 10% of the entire current market capitalization.⁵⁷ The cause for concern about this comes from research on market efficiency, a subject we will touch on in the next Part.⁵⁸ If markets are semi-strong efficient, then investors should not pay to try to beat the market. Even if one doubts the strength of that kind of efficiency,⁵⁹ the evidence is that managed portfolios offered to retail investors on average under-perform indexed portfolios with the same risk characteristics when costs and fees are taken into account. Of course, investors get more from managed portfolios than a chance for positive abnormal return (good record-keeping, customer service, etc.), but the magnitude of expenditures goes well beyond what those ancillary services could justify. Some skewed choice seems at work, which the behavioral research seeks to tease out.

This is not the place to review the empirical and experimental literature or to catalog all the various heuristics and biases that could explain this. That has been done amply elsewhere.⁶⁰ The question regarding the SEC is whether it should assume the task (directly or through FINRA) of “debiasing” investors as part of its mission. If yes or no, why; if at least sometimes, when and how? These questions have a stark ideological dimension.⁶¹ To many, investor “foolishness” is no concern per se, and the securities laws do not grant the Commission plenary authority to remedy poor investor choice. True, but the ideological question becomes much harder when we observe that

⁵⁷ See Kenneth French, *Presidential Address: The Cost of Active Investing*, 63 J. Fin. 1537 (2008). For a similarly dramatic claim about the role of marketing and advertising in economic activity, see Donald McCloskey & Arjo Klammer, *One Quarter of the GDP is Persuasion*, 85 Am. Econ. Rev. (Papers and Proceedings) 191 (1995).

⁵⁸ See Howell Jackson, *To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns*, 28 J. Corp. L. 621 (2003).

⁵⁹ For a discussion of behavioral finance and market efficiency, see Donald C. Langevoort, *Taming the Animal Spirits of the Securities Markets: A Behavioral Approach to Securities Regulation*, 97, Nw. U. L. Rev. 135 (2002).

⁶⁰ E.g., Nicholas Barberis & Richard Thaler, *A Review of Behavioral Finance*, in HANDBOOK IN THE ECONOMICS OF FINANCE (George Constantinides et al., eds., 2003). A recent report for Britain’s FSA contains a good overview of retail investor susceptibility to cognitive bias, and concludes with a dim view of the potential for investor education to overcome these. See DAVID DE MEZA ET AL., FINANCIAL CAPABILITY: A BEHAVIOURAL ECONOMICS PERSPECTIVE (July 2008), available at www.fsa.gov.uk.

⁶¹ See Phillip E. Tetlock, *Cognitive Biases and Organizational Correctives: Do Both Disease and Cure Depend on the Politics of the Beholder?*, 45 Admin. Sci. Q. 293, 320-24 (2000)(evidence that those with a conservative ideology are more likely to doubt both the existence and relevance of cognitive bias).

investor weakness can be exploited for profit, so that some unknown portion of the poor choice is in all likelihood induced. Firms respond strategically to evidence of cognitive bias.⁶² Hence much of the behavioral research focuses on the opportunities for manipulation and persuasion, assuming that firms understand the psychology quite well and act to take advantage of it in various forms, from mass advertising to the interpersonal dynamics of customer-salesperson negotiations. We are right back to the task of defining opportunism within the norms of fair dealing, good faith, and candor embedded in laws regulating the securities industry, which the SEC cannot comfortably ignore.

Many ideas from behavioral economics shed light on this problem. When faced with a complicated choice, people often simplify by focusing entirely on two or three salient attributes of the decision.⁶³ The less able they are to frame the decision in narrow terms, the more often the outcome is one of indecision or procrastination.⁶⁴ When the choice is among investments, which involves comparing numerous options and a high level of cognitive complexity, the bias toward indecision or the status quo is bolstered by the natural risk aversion that accompanies the pursuit of gains. This is one reason why the almost self-evident benefits of saving for retirement through 401(k) plans are taken up by employees more often if they have fewer choices rather than more choices,⁶⁵ and far more often if savings through a preferred plan is the default from which they must opt out, rather than something they must choose.⁶⁶

This poses a severe problem for individual and the economy, suggesting that all other things being equal, investment will be less than

⁶² In many ways, this is the essence of advertising and marketing. See, e.g., Sendhil Mullainathan et al., *Coarse Thinking and Persuasion*, 123 Q.J. Econ. 577 (2008); Langevoort, *Selling Hope, Selling Risk*, supra. On persuasion tactics in the context of selling cigarettes, see Jon Hanson & Douglas Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. Rev. 630 (1999). The field of strategic response to consumer bias is referred to as “behavioral industrial organization.”

⁶³ Daniel Read et al., *Choice Bracketing*, 19 J. Risk & Uncert. 171 (1999).

⁶⁴ This is the source of the well-known phenomenon of “mental accounting” by which choices are evaluated as within a discrete domain even though, rationally, they should be made by reference to other choices and endowments. This is a form of decision simplification. See Richard Thaler, *Saving, Fungibility and Mental Accounts*, 4 J. Econ. Perspectives 193 (1990).

⁶⁵ See Gur Huberman & Wei Jiang, *Offering vs. Choice in 401(k) Plans: Equity Exposure and Number of Funds*, 61 J. Fin. 763 (2006).

⁶⁶ See Richard Thaler & Shlomo Bernartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*, 112 J. Pol. Econ. S164 (2004).

it should.⁶⁷ But most all cognitive biases are contingent and situational, so that decisions can be reframed in a way that makes investing more likely. Behavioral cascades – fads – can occur spontaneously even without industry prompting when people observe others investing successfully. Importantly, if a decision is reframed so that people face the prospect of a loss (falling short of expectation) rather than a gain, risk-seeking behavior goes up. This is Kahneman and Tversky’s famous prospect theory.⁶⁸ Emphasizing certain information can alter perception of gains, losses and risk, enough to change the decision outcome.

Sellers of investment products exploit these tendencies. Studies of mutual fund advertising, for example, show the tendency to highlight past performance strategically, then switch to softer “image” ads when performance lags.⁶⁹ The former exploit investors’ tendency to extrapolate from trends more than is justifiable, since research shows that few mutual funds ever sustain a hot hand net of expenses. Sales interactions often try to induce a loss frame by emphasizing that current patterns of behavior have created the risk of losing status or wealth compared to some reference point (e.g., prompting anxiety that retirees will become a burden on their families later in life).

Two points here bear emphasis. First, the use of the words exploit or manipulate need not be pejorative, much less suggest illegality. Obviously, our culture tolerates pervasive advertising – the essence of which is often at best a half-truth – as part of the engine of economic growth. Moreover, if we assume that the natural product of cognitive bias is under-investment, sellers who overcome this add value both individually and socially. But there is no obvious stopping point to assure that investments sold via subtle manipulations are suitable or preferable to other available choices, which can lead to unnecessary or inappropriate investor expenditures. Second, when faced with complex, difficult and affect-laden choices (and hence a strong anticipation of

⁶⁷ A good example of this is the significant underutilization of annuities in retirement. See Thomas Davidoff et al., *Annuities and Individual Welfare*, 95 Am. Econ. Rev. 1573 (2005). For behavioral explanations, see JEFFREY BROWN ET AL., WHY DON’T PEOPLE INSURE LATE LIFE CONSUMPTION: A FRAMING EXPLANATION OF THE UNDER-ANNUITIZATION PUZZLE, NBER Working Paper 13748 (Jan. 2008), available at www.nber.org/papers/w13748; WEI-YIN HU & JASON SCOTT, BEHAVIORAL OBSTACLES TO THE ANNUITY MARKET (March 2007), available at www.ssrn.com/abstract=978246.

⁶⁸ E.g., Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 Science 453 (1981).

⁶⁹ See SENDIL MULLAINTHANAN & ANDREI SHLEIFER, PERSUASION IN FINANCE (2006), available at www.ssrn.com/abstract=864686.

regret should those choices be wrong), many investors seek to shift responsibility for the investments to others.⁷⁰ This is an opportunity – the core of the full-service brokerage business – to use trust-based selling techniques, offering advice that customers sometimes too readily accept. Once trust is induced, the ability to sell vastly more complicated, multi-attribute investment products goes up. Complex products that have become widespread in the retail sector, like equity index annuities, can only be sold by intensive, time-consuming sales effort. As a result the sales fees (and embedded incentives) are very large, creating the temptation to oversell.⁷¹ In the mutual fund area, the broker channel – once again, driven by generous incentives – sells funds aggressively. Recent empirical research suggests that buyers purchase funds in this channel at much higher cost but performance on average is no better, and often worse, than readily available no-load funds.⁷² The list could go on and on, supporting the fear that much of the excess spending on investment advice that French identifies is induced.

The SEC is by no means unaware of the potential for opportunism through advertising and sales techniques. Much of FINRA's work in sales practices, including broker advertising, directed at this, and the SEC has heavy-handed advertising controls for investment advisers through the so-called brochure rule.⁷³ The regulators are plainly fighting battles, but it is not clear that is had a coherent or consistent approach to their strategy or have chosen a level of intensity to their efforts equal to the challenges that behavioral economics reveals.

My point here is that the insights of behavioral economics are simply too disorienting and daunting for the SEC to embrace them willingly. Consider the role of disclosure. Disclosure works in the sales practice area to the extent that it is salient enough be visible in the dense

⁷⁰ See Langevoort, *Selling Hope*, supra. A vivid example of this can be drawn from the medical field. Studies of those asked to imagine having cancer predict that they would want to be heavily involved in their own treatment decisions, in consultation with their doctors. Studies of cancer patients, however, shows a strong desire to let the doctor make those choices as he or she thinks best. See BARRY SCHWARTZ, *THE PARADOX OF CHOICE: WHY MORE IS LESS* 32 (2004). For more on induced trust, see TAMAR FRANKEL, *TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD* (2006); Claire A. Hill & Erin O'Hara, *A Cognitive Theory of Trust*, 84 Wash. U.L. Rev. 1717 (2006)(offering examples from both medicine and corporate law).

⁷¹ See Exchange Act Release No. 33-8933, June 25, 2008.

⁷² See DANIEL BERGSTRESSER ET AL. , *ASSESSING THE COSTS AND BENEFITS OF BROKERS IN THE MUTUAL FUND INDUSTRY* (2007), available at www.ssrn.com/abstract=616981.

⁷³ See JAMES D. COX ET AL., supra, at 1088.

informational environment the investor is working through. But recall that people simplify by narrowing the product attributes on which they will make their choice; if the disclosure relates to a non-preferred attribute, it will have no effect unless the style of disclosure is powerful enough to make it important. Where savvy advertising or salesmanship has effectively framed the choice for the investor, any required disclosure has to be just as savvy to reframe it. Otherwise, it will play no role in the choice.

The mutual fund area provides a good laboratory, in part because fund flow data permits close empirical scrutiny of sales practices. The industry is highly competitive, offering a wide variety of investment options at different expense levels. Investors respond to certain salient aspects of disclosure quite urgently. New money is heavily directed to higher performing funds than lower ones, particularly in the direct sales (non-broker channel). Performance, in turn, must include deductions for management fees and other direct expenses, which creates some marketplace discipline with respect to these expenses.⁷⁴ But fund companies can frustrate comparisons but segmenting their products into ones with different costs (front end loads, back end loads, etc.), varying costs for some investors but not for others, etc.⁷⁵ Both the SEC and FINRA, to their credit, keep modifying their rules and enforcement practices on fees and expenses to try to keep up, but it is difficult. As the behavioral literature predicts, research documents a large amount of suboptimal investor behavior in this area, even though there is also plenty of smart behavior by others.

I will leave to others further evaluation of regulatory policy here to turn to the obvious behavioral irony. In demanding that funds disclose relative performance adjusted for expenses on a one, three and five year basis so as to facilitate fair rather than unfair comparisons, the rules feed a notorious psychological bias, trend chasing. Retail investors show a significant disposition to believe that past good or bad performance implies a similar future, when it does not.⁷⁶ Nor does the SEC insist on

⁷⁴ See John Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151 (2007).

⁷⁵ For a review, see Mahoney, *Manager-Investor Conflicts*, supra.

⁷⁶ E.g., Prem C. Jain & Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. Fin. 937 (2000). A standard that is influential is the Morningstar rating system, which is a very good mechanism for measuring fund performance against peer performance, thus allowing segmenting into one-star to five-star ratings. Unfortunately, the Morningstar system has little or no forward-looking predictive ability. E.g., Matthew Morey, *The Kiss of Death: A 5-Star Morningstar Rating?*, 3 J. Inv. Mgt. 41 (2005).

identification of the fund's historic "alpha," i.e., that portion of performance attributable to stock-picking skill as opposed to the returns attributable to risk-adjusted market-level performance or simple luck. What it reveals is not particularly impressive. A recent study suggests that about 24% of funds have negative alpha (poor stock picking ability), while the other 76% have a positive alpha – however, for all but a tiny fraction of these, the positive return is less than fees and expenses, often by a significant amount.⁷⁷ The absence of disclosure here means that fund advertising can highlight high absolute returns when the market as a whole performed well, good relative performance when it was lucky enough to outperform its peers, and then go dark on data – fuzzy image advertising – when neither happened.

Nor is there any coherent SEC policy on the disclosure of conflicts of interest in the securities business. Given the pervasiveness and subtlety of the agency costs, styling a formal disclosure obligation that is both accurate and effective is very hard. As a result, enforcement here tends to be after the fact and under-theorized, challenging the nondisclosure of some later-discovered issue as itself false and misleading even though there was no disclosure rule, or in some instances, even though the company complied with a minimal obligation then in effect. Lurking behind these reactive cases is good reason to doubt that disclosures that presumably would have cured the fraud would have done much practical good. Once trust is established (or manufactured) in a relationship, it tends to trump information that the broker has conflicting incentives, especially when they address possibility of conflicts firm-wide rather than anything specific about the broker in question.⁷⁸ Indeed, if they are actually read by the customer, psychological research shows that the effect can be pernicious. People who receive conflict disclosure may well believe that the other party is *more* trustworthy simply as a result of the disclosure. Worse, people making conflict disclosures often feel the freedom to act in a *less* trustworthy way precisely because they made the disclosure.⁷⁹

My point here is not that the SEC is oblivious to behavioral economics. Its economists are aware of the literature, and on rare occasion, the Commission has shown some sensitivity to the psychology

⁷⁷ See LAURENT BARRAS ET AL., FALSE DISCOVERIES IN MUTUAL FUND PERFORMANCE: MEASURING LUCK IN ESTIMATED ALPHAS (May 2008), available at www.ssrn.com/abstract=869748.

⁷⁸ See Langevoort, *Selling Hope*, supra.

⁷⁹ See Daylain Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34, J. Legal Studies 1 (2005)

of disclosure effectiveness. And to be sure, disclosure can have positive effects even when processed poorly by a large segment of investors. Reaction simply by the segment of more careful investors may, in some circumstances, provide a discipline that leads to better behavior.⁸⁰ So there are plenty of benefits that can arise from disclosure obligations beyond their ability to get less mindful investors systematically to make better choices.

What bears emphasis, however, is that by leaving unaddressed large amounts of strategic, psychologically savvy influence tactics by the securities industry, the SEC on balance contributes to the culture of investing.⁸¹ There is an important historical point here that ties our discussion of behavioral economics back to the discussion of light-touch regulation in the previous section. Recall the idea that when there is no strong equity culture, it is very difficult to create. There are strong status quo biases that operate powerfully against putting one's money at risk in other peoples' hands. What prompts the shift, when it happens? Not law, necessarily. Instead, the shift is largely cultural, with aggressive sales and market efforts directed at overcoming popular unfamiliarity and discomfort.⁸² In other words, at an early stage in financial market evolution, salesmanship is probably essential to marketplace development. And such development is a good thing overall for the economy – and for many investors. Thus, regulation that interferes (i.e., debiases effectively by stressing risk) will be harmful to the effort. As a result, we should expect to see a light touch, stressing consumer-investor sovereignty. This is probably a fair assessment of the European situation right now even after the MiFID Directive, which has raised the profile of retail investor protection as a regulatory objective.⁸³

⁸⁰ Compare Edward L. Glasser, *Psychology and the Market*, 94 Am. Econ. L. Rev. 408, 409-11 (2004) (“Markets do not eliminate (and often exacerbate) irrationality. . .”); Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia and Information Suppression in Competitive Markets*, 121 Q.J. Econ. 505 (2006). For a critical discussion of the potential for marketplace correction in the consumer protection area generally, see Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 Minn. L. Rev. 749, 758-61 (2008).

⁸¹ For a critique along these lines, see Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Governmental Neutrality*, 78 Tex. L. Rev. 777 (2000).

⁸² For an interesting discussion of the early days of retail investment in the U.S., see LAWRENCE MITCHELL, *THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY* 92-106 (2007).

⁸³ See Moloney, *supra*. Moloney's analysis of the effort to build a retail investor culture in the E.U. shows the tension in European regulation between this image of investor sovereignty and the competing image of the investor in need of help. See 6 Eur. Bus. Org. Rev. at 395-402. For an updating, still recognizing the “largely

But once the retail equity culture takes hold in a society, there is no reason for the industry to stop. To the contrary, the industry grows and works harder to push investing (particularly in securities that generate high margins) even further. As retail participation in the financial markets becomes more habitual, the pressure to sell grows stronger, and the habituation itself – a form of mindlessness – becomes a market opportunity to exploit.⁸⁴

In other words, a more mature retail financial marketplace is one where debiasing in the face of increasingly sophisticated marketing and sales pressure is probably both more appropriate and less threatening to the markets. Yet we see debiasing only in the most restrained, tentative way from the SEC. The reasons for this deserve more careful scholarly attention. One is legacy: as the U.S. equity markets came into maturity in the 1950's and 60's, SEC regulation was largely disclosure-focused, creating a regulatory habit that is hard to break.⁸⁵ Another is practical. Drafting rules that break through the hard shell of investors' cognitive resistance is hard; enforcing such rules is even harder. But suppose, for example, the Commission wanted to take on the problem of too much cost for too little return in mutual funds, or some kind of conflict of interest. It has other tools in its kit besides rule-making. I have long been intrigued by the almost completely unused power given the SEC to hold public hearings at which witness must produce information and testify under oath to generate greater awareness of acts and practices within the purview of securities regulation (not simply to investigate violations).⁸⁶ The SEC could call directors, officers, stockbrokers,

immature nature of the pan-EC retail investor base,” see Niamh Moloney, *Innovation and Risk in EC Financial Market Regulation: New Instruments of Financial Market Intervention and the Committee of European Securities Regulators*, 32 Eur. L. Rev. 627, 643 (2007). For a good discussion of MiFID as it applies to on-line investing, see Iris H-Y Chiu, *Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation: Some Observations from European Union Securities Regulation*, 2 Va. L. & Bus. Rev. 307 (2007).

⁸⁴ See Lynn Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure and Securities Regulation*, 81 Va. L. Rev. 611 (1995).

⁸⁵ Congress, too, was so inclined. A good example would be the 1954 amendments to the Securities Act of 1933, which revised section 5 to allow aggressive oral solicitations of potential investors in public offerings before the final prospectus was ready for distribution.

⁸⁶ See Sections 21(b) and 22 of the Exchange Act. Nor does the SEC engage in investor education that pointedly demonstrates to investors the subtle ways the industry sells securities. See James Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 Case W. Res. L. Rev. 105 (1998).

analysts and anyone it wishes to account for behavior by Wall Street that it finds troubling, no doubt with substantial media coverage. It doesn't.

All the remaining explanations are political, which makes this another place to observe the institutional boundedness of SEC behavior. Showing an instinct toward self-preservation, the Commission does not see itself as getting into the business of "unselling" securities in the face of a massively successful, century-long effort by the securities industry in the U.S. to cultivate habits of investing by retail participants in the market – even when there is reason to suspect that subtle misinformation and cognitive misperception are at work. The Commission is satisfied to pick and choose discrete practices to attack as abusive without generating either a general theory or deep empirical knowledge about opportunism in the securities business. To do so would probably invite both a massive effort and harsh resistance, especially considering how hard it is in light of the research to draw an acceptable line between legitimate and illegitimate influence tactics. Drawing no line is much easier, allowing the Commission to vary its stance as political conditions permit.

II. "ANTIFRAUD-ONLY" MARKETS

The U.S. securities markets have always been partly institutional, and remain so today. All that has changed is the relative balance – most markets today are more institutional than they used to be, and the growth rate of institutional investment exceeds that of direct retail investment. For example, while we consider the explosive rate of growth in mutual funds and similar kinds of investment companies to be a contemporary occurrence, the fund industry is old enough that its regulation in the form of the Investment Company Act of 1940 was roughly contemporaneous with federal securities regulation generally;⁸⁷ "modernization" of that statute, in turn, occurred in 1970, almost forty years ago.⁸⁸ Institutionalization has always had a place in the securities laws.

With the recent trend toward far greater institutionalization, some important regulatory questions are self-evident. Does the SEC (and/or

Of course, whether investor education of the conventional sort would work in any event is questionable. See DAVID DE MEZA ET AL., *supra*, at 9-10.

⁸⁷ See Mark D. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. Pa. L. Rev. 1469 (1991).

⁸⁸ See Alan Rosenblat & Martin Lybecker, *Thoughts on the Federal Securities Laws Regulating External Management Arrangements and the ALI Federal Securities Code Project*, 124 U. Pa. L. Rev. 587 (1976)(recommending additional reform).

other regulators who have responsibility in financial services) do a good job of protecting retail investors who invest through an intermediary (e.g., does the '40 Act need another round of reform⁸⁹)? As new products blur the boundaries among different regulatory regimes, is the overarching system coherent? Should we regulate institutions, like hedge funds, that have taken on importance unimagined when regulatory lines were first drawn?⁹⁰ All these have received ample attention in the recent literature and so, as important as they are, I will leave them to others.

Other questions are a bit more subtle, such as whether (and if so when) we can relax protection for retail investors because of the greater presence of institutions. This is the idea behind a number of reforms that invoke market efficiency as a metric, which presumably is largely driven by institutional trading, as grounds for deregulation. Examples would be shelf registration and simplified disclosure for well-known issuers. These, too, have received their due,⁹¹ though probably more thought needs to be given to the conflicts that emerge when institutions seek to profit from retail naiveté. We have reason to suspect that institutions often “ride” bubbles rather than counteract them, and in the process probably make them bigger before they pop.⁹² Indeed, as the formation of private pools of capital becomes easier and technology assists in the gathering and analysis of investment-related information, private money will more aggressively seek out profitable opportunities even in small company settings. We see this at work in the phenomenon of PIPE financing (private investment, public equity), whereby private investors – often hedge funds – invest in a company pursuant to an agreement whereby the company agrees to register a public offering to facilitate the exit of the private investors through sales to retail and other public investors.⁹³ As a regulatory matter, PIPE financing occurs only if the

⁸⁹ See, e.g., Martin Lybecker, *Enhanced Corporate Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration*, 83 Wash. U.L.Q. 1045 (2005); Alan Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 Brook. J. Corp. Fin. & Comm. L. 165 (2007)..

⁹⁰ E.g., Troy Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style and Mission*, 2006 U. Ill. L. Rev. 975 (2006).

⁹¹ See Barbara A. Banoff, *Regulatory Subsidies, Efficient Markets and Shelf Registration: An Analysis of Rule 415*, 70 Va. L. Rev. 135 (1984); Merritt Fox, *Shelf Registration, Integrated Disclosure and Underwriter Due Diligence: An Economic Analysis*, 70 Va. L. Rev. 1005 (1984); Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. Pa. L. Rev. 841 (1992).

⁹² Cite.

⁹³ See William Sjostrom, *PIPE's*, 2 Ohio St. Entrep. Bus. L.J. 381 (2007).

SEC allows the second-step offering to be registered as a secondary offering by selling shareholders, rather than as a primary offering by the issuer (for which the private investors might be deemed underwriters, and thereby face liability risks and other regulatory obligations). While these are not abusive per se, and are a means by which smaller issuers unable to access the public markets directly for equity financing can do so indirectly, there are also severe problems here (e.g., so-called “death spiral” financing, insider trading, etc.⁹⁴) This is an illustration of a more complicated relationship between retail investors and the process of institutionalization: institutionalization creates both the motive and opportunity to exploit weaknesses anywhere in the financial markets. To the extent that the relative efficiency of the market for large cap issuers makes profit opportunities less and less discoverable, the effort will gravitate toward more retail-investor dominated settings.

In this section, I mainly intend to elide these questions and instead engage in a thought experiment, imagining the emergence of deep, liquid trading markets for corporate securities in the U.S. that are *entirely* institutional.⁹⁵ What would securities regulation look like as applied to that kind of market? What I want to test here is the supposition that these would truly be “antifraud-only” markets, with no legally mandated disclosure or corporate governance rules, affording redress only in cases of fraud. We currently have such unregulated markets for particular securities and other investment products, including the kinds of collateralized debt obligations and other structured products involved in the most recent investment crisis. The specific institutional detail underlying the crisis is well worthy of careful exploration. However, I want to think more boldly by taking the most visible antifraud-only market, the 144A market, and imagine that it grows to a scale comparable to the public markets we have today – a global trading site for the stock of large numbers of issuers who now are public companies.

The decision by Congress to exempt non-public offerings from the registration requirement of the Securities Act of 1933 sets the rhetorical framework here, dividing offerings between those made to persons who need the protection afforded by registration and those who

⁹⁴ See *Compudyne Corp. v. Shane*, 453 F. Supp.2d 807 (S.D.N.Y. 2006).

⁹⁵ Steve Choi’s often-cited article wherein he suggested the possibility of banning unsophisticated retail investors from sophisticated trading markets anticipates this thought experiment. See Stephen Choi, *Regulating Investors, Not Issuers: A Market-Based Proposal*, 88 Cal. L. Rev. 279 (2000).

don't.⁹⁶ From that point on, the SEC has had to think about who needs protection, if so why, and if not why not. At the risk of substantial oversimplification of an overwhelming complicated subject, the Commission finally determined in the early 1980's that in terms of original placements by issuers, sufficient wealth *or* sophistication on the part of the investors was enough to justify lack of registration.⁹⁷ That wealth measure ("accredited investor" status), though perhaps substantial then, has now been eroded by inflation so that most solidly upper middle-class investors now readily qualify.

But a more vexing problem lurked. Investors strongly desire liquidity, and '33 Act exemptions essentially required a lock-up of unregistered securities until they had "come to rest" in the qualified investors hands. The result was a liquidity discount that reduced the proceeds to the issuer. As a partial effort to overcome this, the SEC decided in 1990 to adopt Rule 144A, which allowed "qualified *institutional* buyers" (not just wealthy or sophisticated investors) to resell freely at any time and in any amount so long as the buyer was another QIB.⁹⁸ In so doing, the Commission set in motion the most interesting, and portentous, issue associated with institutionalization. Is it good public policy to allow or encourage the development of purely private investment markets like this, and if so, how?⁹⁹ In the last twenty years, the 144A market has grown substantially, and technology has reached a point where secondary trading can be done at low cost and high speed, bringing the liquidity discount down. We have reached a point where it is entirely plausible for an issuer to raise capital in the private market with the expectation that it is the economic equivalent to a registered public offering (but with far less mandatory disclosure and liability exposure, and hence lower cost). The first of these are starting to occur.¹⁰⁰

At this point, however, the 144A market has two significant limitations that make it an imperfect alternative. First, securities sold pursuant to Rule 144A cannot be fungible with securities traded in a

⁹⁶ See *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

⁹⁷ For a good discussion, see Mark Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 Wash. U.L.Q. 225 (1990); Edward Fletcher, *Sophisticated Investors Under the Federal Securities Laws*, 1988 Duke L.J. 1081.

⁹⁸ See JAMES D. COX ET AL., *supra*, at 377-83. For a thorough discussion that takes Rule 144A up to its present status, see William Sjostrom, *The Birth of Rule 144A Equity Offerings*, 58 UCLA L. Rev. (2008).

⁹⁹ For a preliminary discussion of this, see Langevoort, *Animal Spirits*, *supra*.

¹⁰⁰ See Cartwright, *supra*.

public market; second, only QIB's – roughly, those managing more than \$100,000,000) – are currently eligible to participate as buyers. The effect of these twin limitations is that 144A securities (or options thereupon) cannot be given as compensation to executives and employees, or otherwise usable to unlock value for non-institutional founders and promoters, which limits its ability to be a close substitute for the public markets.

But that is by regulatory choice, which brings us to the thought experiment. Why not alter the eligible investor criterion to come closer to accredited investor status? Perhaps not as low as the current definition, which the SEC has considered increasing in any event,¹⁰¹ but something that would comfortably include high net worth individuals¹⁰² and (perhaps) high-ranking corporate insiders when buying or selling company shares. That would further enhance the liquidity of the private 144A market and bring it closer to being a public-market substitute. Arguably we would also have to tweak a handful of other regulatory requirements in order to find substantial parity, such as relaxing or jettisoning the ban on general solicitations in the Reg D private placement exemptive safe harbor.¹⁰³ But again, this is simply a thought experiment, so we can simply assume that all the necessary pruning has taken place.

What I am saying, of course, is that we are not very far as a matter of either law or economics from primary and secondary markets that are closed to retail investors but have marketability, depth and liquidity just like public ones. If the SEC so chooses, they could be, essentially or entirely, antifraud-only markets. And if that is appealing enough to issuers, they presumably would have the choice to issue and have their securities trade solely in the private market, offering a nice market test of the relative costs and benefits of the regulation that being in the public market triggers. Indeed, recent criticisms of U.S. public market regulation points to the growth of the 144A market as persuasive evidence of gross regulatory inefficiency in for public markets.¹⁰⁴

¹⁰¹ See Sec. Act Rel. No. 33-8766.

¹⁰² E.g., “Qualified Purchaser” as defined in Section 3(a)(54) of the Securities Exchange Act, which brings in natural persons with assets under investment of more than \$25 million.

¹⁰³ See JAMES D. COX ET AL., *supra*, at 300-07

¹⁰⁴ See INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 45-47 (Nov. 30, 2006), available at www.capmksreg.org; see also COMMITTEE ON CAPITAL MARKETS REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET 17-20 (Dec. 4, 2007), available at *id.*

There is an economic argument for mandatory disclosure regulation even in a market made up entirely of sophisticated investors. Collective action difficulties, free-riding and the problem of duplication of effort make it such that a single standard setter (and enforcer) might be more efficient than leaving the market to reward or penalize the disclosure that issuers choose to make or not make on their own. If this were the only reason for regulation, however, it is not unreasonable to believe that stock exchanges or some other private body might be better than the SEC at setting these standards. I do not want to pursue this particular question, however, because it has been so thoroughly discussed in the law review literature – indeed, it was probably the most important topic in securities regulation scholarship during the 1980s and 90s.¹⁰⁵

To address the need for or benefits from mandatory disclosure and related regulatory interventions for an institutional market, we should start with the most interesting – though far from dispositive – part of this exercise. Does what we know about the behavior of institutional investment managers suggest that they act consistently in the diligent, rational manner we would expect from educated, highly-incentivized people who are engaged in repeat-play activities? There are two schools of thought here. One draws from research in both behavioral economics and organizational behavior that identifies systematic judgmental biases that seem to affect economic behavior even among so-called experts.¹⁰⁶ Overconfidence and optimism biases, for example, are common explanations for excess entry into certain fields. Sunk cost biases – the inclination to persist in an increasingly losing enterprise – are readily observable as well, as are examples of decision simplification that ignore important external signals.

The standard economic objection to this is that such biases, even if they are natural and commonplace, will not survive the pressures of

¹⁰⁵ See, e.g., John C. Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Va. L. Rev. 722 (1984); Frank Easterbrook & Daniel Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984); Paul G. Mahoney, *The Exchange as Regulator*, 83 Va. L. Rev. 1453 (1997); Marcel Kahan, *Securities Laws and the Social Cost of “Inaccurate” Stock Prices*, 41 Duke L.J. 977 (1992); Merritt Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 Va. L. Rev. 1335 (1999).

¹⁰⁶ E.g., Michael Haigh & John A. List, *Do Professional Traders Exhibit Myopic Loss Aversion? An Experimental Analysis*, 60 J. Fin. 523 (2004)(professional traders show more myopic aversion than control group). There is field study evidence as well. E.g., GUILLERMO BAQUERO & MARNON VERBEEK, DO SOPHISTICATED INVESTORS BELIEVE IN THE LAW OF SMALL NUMBERS?, available at www.ssrn.com/abstract=891309.

competition. Weak decision-makers will be weeded out; the strong will survive. This is a complicated subject that we cannot explore in detail. Rather, just a couple of important points. First, competition is key – for monopolists and other institutional investors who do not have to compete aggressively, the Darwinian discipline diminishes. And there are many institutional investors (state and local governments, public pension funds, etc.) that operate in relatively uncompetitive settings. Those who do compete for retail investor funds may find themselves with ambiguous incentives. Some segments of the mutual fund industry, for example, compete for funds in channels where sensitivity to performance is less than in other channels. Second, performance feedback in investing can itself be ambiguous. Take, for example, an overconfident portfolio manager who makes unjustifiable bets. Over large numbers of iterations, many of these will be weeded out, but some segment – by blind luck – will strike good fortune. It is quite difficult to disentangle skill from luck in dynamic markets except over long periods of time, and when markets are moving upwards generally so that many bets are paying off, that much harder. The foolish but lucky can survive, even flourish.¹⁰⁷

That is one school. The other is more doubtful about the ability of such biases to persist and points out that much of what we have just described are simply manifestations of agency costs. In other words, assume that portfolio managers are entirely rational and opportunistic. They will not maximize returns to their investors if their personal incentives point in a different direction and marketplace discipline weak. In a setting where compensation is a percentage of assets under management (e.g., mutual funds), we are likely to observe herding among portfolio managers – buying, holding and selling particular securities because that is what other funds managers are doing. This is because for all the benefits that come from outperforming one's peers, the risk of job termination from comparatively poor performance is worse. Hence, herd behavior that is easy to see as a form of psychological bias (social proof) can also be rational.¹⁰⁸ Likewise, if for

¹⁰⁷ There is also evidence that younger managers, without the “wisdom” of experience from previous stock price crashes, bet more heavily on technology stocks in the late 1990's. See ROBIN GREENWOOD & STEFAN NAGEL, *INEXPERIENCED INVESTORS AND BUBBLES* (June 2008), NBER Working Paper 14111, available at www.nber.org/papers/w14111.

¹⁰⁸ E.g., Nishant Dass et al., *Mutual Funds and Bubbles: The Surprising Role of Contractual Incentives*, 21 *Rev. Fin. Studies* 51 (2008); Mark Grinblatt et al., *Momentum Investing Strategies, Portfolio Performance and Herding: A Study of Mutual Fund Behavior*, 85 *Am. Econ. Rev.* 1088 (1995). There are multiple reasons for

some reason like bad luck the manager does fall behind visibly, the natural incentive is to take on a greater than optimal level of risk to try to catch up – gambling with house money.¹⁰⁹ Much work in financial economics today seeks to disentangle behavioral from agency cost explanations for marketplace defects, but the effort is a challenge. Related to this are ways in which the behavior of even rational portfolio managers is constrained by sentiment-driven retail pressures. Retail investors will have an indirect influence on the private market to the extent that they aggressively put money in (or take money out of) mutual funds and similar institutions that must invest in certain categories of investments.¹¹⁰ During the tech stock bubble of the late 1990's, some of the upward pressure on prices likely came from the immense amount of retail money that went into technology-based stock funds that were effectively required to find *some* tech stocks in which to invest it. Those that stayed away from an aggressive position in such stocks paid a severe market price for their prudence.

Whether or not we assume judgmental bias on the part of portfolio managers, there is likely to be some level of suboptimal investment behavior even in entirely institutional markets. Both behavioral and agency cost explanations invite strategic behavior from sellers of investment products, so that opportunistic sales practices in the institutional market will be both profitable and troubling. Thus there is at least a prima facie case for regulation in these kinds of settings.¹¹¹

By itself, however, the suspicion that there might be suboptimal investor behavior in the enhanced private market we are imagining would not make the case for strong issuer disclosure regulation by the SEC. As financial economics has long pointed out, the presence of smart money can neutralize the harms that come from noise traders through arbitrage.¹¹² The weight of research on institutional traders is that they

herding beyond reputational incentives; those incentives, however, are well recognized as an important causal explanation. See David Scharfstein & Jeremy Stein, *Herd Behavior and Investment*, 80 Am. Econ. Rev. 465 (1990).

¹⁰⁹ See Jeffrey Brown, *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. Fin. 85 (1996).

¹¹⁰ See, e.g., JORGE CHAN-LAU & LI ONG, U.S. MUTUAL FUND RETAIL INVESTORS IN INTERNATIONAL EQUITY MARKETS: IS THE TAIL WAGGING THE DOG?, IMF Working Paper No. 05/162, available at www.ssrn.com/abstract=876384.

¹¹¹ For a discussion of selling practices in the subprime mortgage financial market, see Steven L. Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, Utah L. Rev. --- (forthcoming, 2008).

¹¹² An interesting question would be the extent to which the private market encourages short-selling to a greater extent than permitted in the public. Short selling constraints are an important reason for less than full market efficiency in the public markets. If so,

are often savvy, and if we are assuming the absence of retail traders from this market – generally agreed to be the major source of noise¹¹³ – efficiency conditions are that much better. To the extent to which we further assume that the institutional participants are both wealthy and diversified the residual harm that comes from random instances of poor disclosure is absorbed with less pain. The latter may actually be the real explanation for what we mean by investors who do not need the protection of the securities laws – they can and do suffer at the hands of opportunists, but rarely drastically. As such, they can more easily be told simply to learn from the experience and not repeat the mistake,¹¹⁴ or seek damages if they can show fraud.

That is the case for an antifraud-only market. Disclosure and compliance costs borne by issuers and investors would presumably come down to some extent,¹¹⁵ and issuers would be free of the Sarbanes-Oxley style rules that critics say unnecessarily burden corporate governance and disclosure practices. The costs and benefits of disclosure rules are difficult to parse through, and vary considerably based on the size, structure and business of the issuer. Many forms of governance are substitutes for each other; one size does not fit all. Assuming a reasonably efficient, institution-driven private market, the likelihood that the market could fairly price the chosen forms of disclosure and governance makes it likely that investors on average would be better off

greater efficiency is possible, but at a price – issuer management is typically hostile to short-selling pressure, and encouraging short-selling could put the private market at a disadvantage in the competition for issuer listings.

¹¹³ A classic study is Charles M.C. Lee, *Earnings, News and Small Traders*, 15 J. Acct'g & Econ. 265 (1992). For more recent extensions, see, e.g., Alok Kumar, *Hard to Value Stocks, Behavioral Biases and Informed Trading*, J. Fin. & Quant. Analysis (2008); Ulrike Malmendier & Devin Shanthikumar, *Are Small Investors Naïve About Incentives?*, 85 J. Fin. Econ. 457 (2007); Zur Shapira & Itzhak Venezia, *Patterns of Behavior of Professionally Managed and Independent Investors*, 25 J. Banking & Fin. 1573 (2001).

¹¹⁴ Learning from experience is often difficult, but professional traders (those around long enough to have both positive and negative feedback, have both the incentive and capacity to learn. See, e.g., John List, *The Behavioralist Meets the Market: Measuring Social Preferences and Reputation Effects in Actual Transactions*, 114 J. Pol. Econ. 1 (2006). In the short term, however, even professionals may exhibit significant bias. See note --- supra.

¹¹⁵ A study of capital raising transactions under Rule 144A compared to conventional registered offerings found a drop, though perhaps not as dramatic as some would expect. Institutional buyers in 144A deals insist on a high level of protection, including mandatory disclosure (and so-called 10b-5 representations). See Howell Jackson & Eric Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999*, 56 Bus. Law. 653 (2001).

as compared to detailed mandatory rules where there is no means of escape. And almost certainly, corporate governance would be improved in an institution-only market because of shareholders' greater practical ability to coordinate to exercise their law-given powers, creating one more avenue of recourse in the event of managerial abuse.

So let us assume that such a private, institution-only market would be attractive enough to issuers that large numbers migrate to it.¹¹⁶ Would the antifraud-only approach be politically stable? My prediction is that the SEC would not, ultimately, be willing to leave issuer transparency in this market so unregulated (nor would Congress allow it to). The point is not as simple as regulatory aggrandizement, i.e., that the SEC has an instinct for intervention simply to expand the scope of its reach. I am convinced that part of the motivation for the substantive and procedural disclosure requirements of U.S. securities regulation increasingly is disconnected from shareholder or investor welfare per se, and instead relates to the desire to impose norms that we associate with public governmental responsibility – accountability, transparency, openness and deliberation – to institutions that have comparable power and impact on society. It is a familiar point that many large corporations have more economic power than many counties and cities, perhaps even a handful of states.

When Enron and Worldcom fell, the harm was fairly diffused among investors. The markets for both companies' stock were heavily institutional, and so far as conventional retail investors were concerned, putting aside some aberrant exceptions, losses were confined to portions of portfolios. Painful, but absorbable. The dramatic pain was felt by

¹¹⁶ I am assuming here a continuation of the non-fungibility rule, so that issuers would have to choose one or the other markets for any given class of security, and would have to avoid publicly traded securities altogether to gain freedom from the basic disclosure responsibilities that are imposed on registrants. Thus we are not facing potential fragmentation of trading interest in what is essentially the same security, removing that particular market regulation issue as a concern. See JAMES D. COX ET AL., *supra*, at 1012-21. So, the effect depends simply on issuer choice as to which market it prefers. I am well aware, of course, that managers might well decide that they like public markets better precisely because of the greater opportunity for entrenchment and manipulation of noise traders, so I am not predicting that the choice would be the private market. During periods when sentiment regarding some sector or the market as a whole is especially optimistic or pessimistic, issuers can exploit the inefficiencies by issuing or repurchasing, and managers can engage in either lawful or unlawful insider trading. As we saw earlier, Wall Street gains in many ways from taking advantage of (some would say manipulating) investor sentiment; if so, then it may encourage issuers and insiders to choose public rather than private market access in corporate financing decisions.

employees of the company, who lost their jobs and in many cases – because of inadequate diversification in employee pension accounts – significant retirement savings. There were also spillover effects on local communities. Separately, the impact of the underlying fraud on competitors of the two companies was staggering: Greg Sidak has estimated that the Worldcom fraud caused some seven billion of dollars in harm to companies like Sprint, Verizon and AT&T.¹¹⁷

As I have explained more fully elsewhere, much of Sarbanes-Oxley matches rather remarkably with an administrative law-like conception of what the American public increasingly demands of public institutions, particular in its effort to enhance transparency (risk disclosure, internal controls, etc.), accountability (executive certification requirements), open deliberation (auditor involvement, audit committee responsibilities, etc.) and outside voice (independent directors, employee whistle-blowing, etc.) as against the secretive exercise of managerial autonomy.¹¹⁸ That these have potential benefits for investors as well is certainly possible – while others might, I am not suggesting that Sarbanes-Oxley and contemporary securities regulation are investor-insensitive. These changes were partly, if not entirely expertly, designed to restore investor confidence.¹¹⁹ But investors have a great capacity to tolerate risk and benefit from risk-taking; the effect of the legislation, it seems clear, is somewhat greater risk aversion.¹²⁰

If that is right, then we shouldn't expect the SEC or the public to be comfortable with a large-scale shift of issuers to a private market in

¹¹⁷ See Gregory Sidak, *The Failure of Good Intentions: The WorldCom Fraud and the Collapse of American Telecommunications After Deregulation*, 20 Yale J. Reg. 207 (2003).

¹¹⁸ See Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley*, 105 Mich. L. Rev. 1817, 1828-33 (2007). For a somewhat similar argument, see Cary Coglianese, *Legitimacy and Corporate Governance*, 32 Del. J. Corp. L. 159 (2007).

¹¹⁹ Put another way, in the aftermath of Enron and Worldcom there was substantial doubt that there was enough regulation to deal with the incentives to cheat; at the same time, there was also substantial doubt about whether, and if so what, strategies could make deterrence stronger without costs and consequences worse than the cure. There were ideas on how to respond, plausible enough, though very little hard data to bolster them. Responding to immense political pressure, Sarbanes-Oxley took a scattergun approach. In all likelihood, some will prove to have been good ideas, others not, largely depending on the quality of implementation by the SEC and PCAOB. From an investor standpoint (especially a risk-neutral or risk-preferring institution), then, the cost-benefit balance of the reforms in the aggregate is unclear. But because these reforms more clearly respond to other stakeholder concerns as well, the political choice, though risky, had merit enough to justify it as public-regarding legislation.

¹²⁰ See LEONCE BARGERON ET AL., *SARBANES-OXLEY AND CORPORATE RISK-TAKING* (March 2008), available at www.ssrn.com/abstract=1104063.

which these public claims simply disappear, even if it decides that investors themselves would be better off. To be sure, the private equity buy-outs of the last decade or so have that same effect. But the numbers of private large companies in the U.S. are still relatively small, and largely temporary in the sense that many return to public status after a brief period under private equity control. Our thought experiment here is to imagine a private market in which significant numbers of prominent companies choose to “go dark.” That, I suspect, is politically and normatively unsustainable.

Will it happen anyway, simply by virtue of the continued growth of the 144A market? Current law on this subject is worth considering. The 144A trading market is not considered an “exchange,” so that issuers included in the secondary trading system are not exchange-traded and therefore not subject to the Securities Exchange Act’s on-going disclosure requirements under Section 12(b). Even as this market becomes enhanced in terms of order execution, clearing and settlement, it could fall outside the definition of an exchange because the SEC has chosen to limit exchange status to public exchanges and let proprietary trading systems operate under lesser regulatory constraints.¹²¹ But in 1964, Congress added a distinct basis for registration under Section 12(g) of the ’34 Act: if the issuer has more than 500 shareholders of record and more than a certain amount of assets (currently \$10,000,000 by virtue SEC rule 12g-1), it has public company disclosure responsibilities for that reason alone. Except for foreign issuers, 12(g) status has the same effect as 12(b) status.¹²²

There are only two means of avoiding public company status even in a non-public market. One is to have fewer than 500 shareholders in total, which is impracticable with respect to a large scale offering (particularly if we are thinking in terms of an enhanced private marketplace). The other is to have more than that many shareholders but have shares in that particular marketplace held *of record* by a depository or other centralized location for the benefit of the real shareholders. There are a number of places in the ’34 Act where beneficial ownership is the regulatory trigger, but Section 12(g) uses the narrower test of record ownership. On its face, this allows the architect of a non-exchange marketplace the ability to avoid public company responsibilities for issuers traded solely inside the system simply by styling the shareholding arrangements as mandatory collective

¹²¹ See Reg ATS, discussed in JAMES D. COX ET AL., *supra*, at 1021.

¹²² *Id.* at 548-53.

depository accounts, keeping the number of record holders to a minimum.

This is an interesting and largely unexplored area. As markets evolve, the fragility of the record ownership standard in Section 12(g) will surely be tested. The SEC has adopted Rule 12g5-1 to define “of record,” and to this point it is mainly an effort to provide objective standards for close judgment calls (e.g., whether there are one or two record holders when a security owned jointly by two co-owners). The subjective exception is subsection (b)(3), which instructs issuers to count as record holders any beneficial owners when it “knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of Section 12(g)” (i.e., avoid registration when there apparently should be registration). Arguably, this could be invoked by the Commission when public company status is defeated simply by architectural design.

Even if not, however, the SEC still has fairly plenary control over the issue. After all, it would take its acquiescence for the 144A market to become enhanced enough to truly compete with the public markets, which it could condition only additional disclosure requirements if it wished. So, too, with the question of whether the private market trading system is an exchange or not – in fact, the statutory definition of exchange in the ’34 Act easily reaches private trading markets but for SEC liberalization in this area. That could be revised or withdrawn. Hence, this issue remains one for the Commission to decide.

Thus, my expectation is that we will not see the emergence of private “antifraud-only” markets that rival the public markets. There are other political obstacles as well – certainly the politically powerful public stock exchanges will not take kindly to the emergence of private rivals. Although large Wall Street investment firms might be indifferent because they have the ability to profit from the private as well as public investment activity (indeed, they are the ones currently seeking to enhance the 144A market), regional and smaller broker-dealer firms and many others (e.g., the financial media) will resist privatization as well.

The result of our thought experiment, then, is this: we can expect to see continued growth in the private market, particularly for debt and preferred stock and for the securities of foreign issuers. Perhaps the SEC might think about expanding the market by redefining who is an eligible investor. But as soon as it thinks about the consequences of accepting a private market alternative, it will either decide otherwise or embark on a process of facilitating the growth that by regulatory conditioning, making the alternative marketplace a site of significant regulation as well.

III. THE INTERNATIONAL COMPETITIVE EQUILIBRIUM

Globalization competes with institutionalization as the most common causal explanation for fundamental change in the contemporary capital marketplace. Actually, the two are quite closely related. My aim in this last Part is to explore that symbiosis and show how many of the hardest issues relating to globalization are variations on the thought experiment conducted in Part II regarding antifraud-only private markets.

In terms of legal background, foreign issuers can seek out U.S. investors in ways that trigger greater or lesser degrees of U.S. securities regulation. They can register a public offering under the '33 Act, for example, and/or list their securities on a U.S. exchange. These bring on fairly comprehensive disclosure requirements, though not quite at the level domestic issuers face, and undiluted liability risks.¹²³ Foreign issuers can avoid '33 Act registration, however, by making a private placement (often pursuant to Rule 144A, discussed earlier), and if they are not cross-listed on a U.S. exchange, the SEC has exempted them from most disclosure burdens even if they have a significant number of U.S. shareholders.¹²⁴ Recent evidence suggests that foreign issuers have become somewhat more hesitant to register with the SEC;¹²⁵ what that means for U.S. investors is less information and direct access to non-cross listed foreign securities. But technology has substantially reduced this burden trading in such stocks for those who seek them out, and brokerage firms like Charles Schwab and E-trade now aggressively advertise that their customers can cheaply direct trades to markets around the world.

Most U.S. retail investor participation in global securities investment is institutionalized, to a greater extent than domestic investment. Presumably, this reflects less familiarity with foreign issuers and markets; there has long been a well-known "home bias" on the part of investors.¹²⁶ Investment in foreign issuers is growing, however, among both retail and institutional investors.

There are three related issues here, all of which the SEC has expressed an interesting in addressing through some forms of regulatory

¹²³ See JAMES D. COX ET AL., *supra*, at 222-225.

¹²⁴ *Id.* at 551-553.

¹²⁵ See note --- *supra*.

¹²⁶ E.g., Gur Huberman, *Familiarity Breeds Investment*, 14 *Rev. Fin. Studies* 659 (2001).

liberalization. The first, and easiest, is whether to allow U.S. brokers to have foreign trading screens¹²⁷ – i.e., direct access to foreign stock exchanges – so as not to force them to use a second intermediary in the other country to execute a customer’s trade. Under current law, which the Commission is considering changing, having trading screens would arguably establish a presence in the U.S. on the part of the foreign exchange, subjecting it to a registration requirement (and attendant regulation) here. Because technology has made trading so feasible anyway, even with double intermediation, this is mainly just a cost issue.

The second is whether foreign brokerage firms can establish a physical or on-line presence by soliciting U.S. investors to make trades, without having to register (and be regulated) as U.S. broker-dealers. The SEC recently proposed an expanded rule that would allow such access as to institutional and very wealthy U.S. investors, but drew the line far short of retail investors.¹²⁸ Here, we see hints of a much talked-about subject – mutual recognition.¹²⁹ Although this particular rule proposal is not dependent on a showing that the broker-dealer firm is well regulated in its home country, SEC officials have indicated a willingness to think about further liberalization, including access to a greater number of individuals and households, so long as the SEC finds that the regulatory system in the home country is sufficiently comparable with what is found in the U.S.¹³⁰ If so, then U.S. securities law becomes antifraud-only as applied to the foreign actors.

The third setting extends this same idea of mutual recognition to issuer disclosure requirements, at least with respect to the trading of securities in the U.S. Dependent once again upon a showing of sufficient comparability, this would mean that the home country sets the disclosure standards and attendant corporate governance rules even if the foreign company is listed on the New York Stock Exchange or Nasdaq. Most Sarbanes-Oxley requirements would thus disappear. Somewhat more conservatively, the SEC might designate securities from foreign countries as “world class issuers” upon a showing that they had both

¹²⁷ Howell Jackson et al., *Foreign Trading Screens in the United States*. 1 Cap. Mkts. L.J. 54 (2006).

¹²⁸ This would amend SEC rule 15a-6, which deals with registration by foreign broker-dealers. See Exchange Act Rel. No. 58047, June 27, 2008.

¹²⁹ For a set of ideas put forward by SEC officials, see Ethiopis Tafara, & Robert Peterson, *A Blueprint for Cross-Border Access to US Investors: A New International Framework*, 48 Harv. Int’l L.J. 31 (2007).

¹³⁰ Id. at 59-61; see also Eric R. Sirri, Director, SEC Division of Trading and Markets, *A Global View: Examining Cross-Border Financial Services*, Whistler, B.C., Canada, Aug. 18, 2007, available at [ww.sec.gov/news/speech/2007/spch081807ers.htm](http://www.sec.gov/news/speech/2007/spch081807ers.htm).

sufficiently comparable securities regulation in their home country and a large enough capitalization among unaffiliated shareholders.¹³¹ This latter test would be a proxy for a high level of institutionalization. Whatever test is used, we would have an antifraud-only regime with respect to foreign issuer disclosure.

The connection between globalization and institutionalization becomes clear here. But before turning to this issue directly, another connection deserves note. The U.S., Canada and Australia are the only countries in the world that have a reasonable mature retail investor base for direct equity investment. In all other countries, the setting is far more institutionalized: to the extent that individuals and households invest in equity securities at all, it is through intermediaries. As we saw in Part I, the EU wants to encourage more direct retail participation, and Great Britain is the place in Europe where this is most feasible. But even there, change is slow in coming. European institutionalization stems from historical misfortune. In the late nineteenth century, European stock exchanges had flourished by reaching out to a wide range of investors – what we would call retail investor participation was greater in Western Europe than in the U.S. But the devastation of two world wars a few decades later destroyed that economic base, and as Europe rebuilt its financial markets in the difficult post-war periods, it retained substantial governmental involvement and control in those markets.¹³² Banks, pension funds, insurance companies and the like were the investment vehicles of choice.

What this means is that contemporary European securities regulation has been designed specifically with an institutional marketplace in mind. In this sense, the institutionalization of the U.S. markets is making them more European, and hence we might look at European securities regulation – more principles-based, less reliant on intensive enforcement – as models for what institutionalization-driven regulation should look like. In turn, this impression has much to say about mutual recognition.

Put bluntly, mutual recognition is hard to justify as applied to the retail securities industry. For the reasons developed in Part I(A), European securities regulation lacks most of what the U.S. has built over some seventy years in terms broker-dealer regulation. In the U.S., much

¹³¹ See John White, SEC Director of Corporation Finance, *Corporation Finance in 2008–International Initiatives*, at www.sec.gov/news/speech/2008/spch011408jww/htm.

¹³² See Mark Roe, *Legal Origins, Politics and Modern Stock Markets*, 120 Harv. L. Rev. 460 (2006). In the U.K., tax policy and other factors also contributed to increasing institutionalization after World War II. See Armour & Skeel, *supra*, at 1768-70.

of the work is done by the major self-regulatory organization, FINRA, whose principles and rules are replete with retail-investor oriented protections. It oversees a large dispute resolution system that handles most investor claims against brokers. While self-regulation may be open to criticism when compared to direct administrative regulation, the European system has nothing comparable at either the self-regulatory or administrative level. So far as mutual recognition is concerned, then, it would be hard to find sufficient comparability without major expansion of capacity and experience in applying the law to a retail base. This might be jump-started to the extent that foreign brokers entering the U.S. on a mutual recognition basis were required to submit to FINRA supervision, but this would at the same time diminish the benefits of the system and raise awkward anticompetitive issues.

On the other hand, European regulation seems better suited to establishing a disclosure regime for issuers with a largely institutional ownership base, because that is what it has always had. On disclosure, Europe is reasonably thorough in how it addresses on-going issuer disclosure and the potential for market abuse.¹³³ In terms of formal regulatory demands, there are numerous ways in which what it insists on from issuers actually exceeds what we have in the U.S. But it is also far less enforcement-oriented,¹³⁴ presumably because of two major distinguishing features: (1) institutional investors themselves are better able to exert various forms of pressure on managers that lessen the need for post hoc litigation; and (2) the issuer community is smaller and more concentrated, so that formal and informal sources of suasion by regulators are more potent.¹³⁵ As the European capital market grows and becomes more diverse – including somewhat greater retailization – these features are likely to weaken, so that we might expect greater enforcement intensity in the future¹³⁶ (indeed, there are already some signs of this). Any increase in enforcement intensity that comes close to matching what we observe in the U.S., where a different, retail-driven demand exists, is implausible.

The question that the U.S. would face under a mutual recognition regime is whether that kind of institutional investor-oriented approach could properly be considered sufficiently comparable to allow it as antifraud-only. This is a version of the thought experiment in Part II, but made more challenging by the increased retail demand for foreign

¹³³ This was the subject of the EU's Market Abuse Directive.

¹³⁴ See Coffee, *supra*.

¹³⁵ See FERRAN, *supra*; ARMOUR, *supra*.

¹³⁶ See ARMOUR, *supra*, at V-21.

stocks, which means that retail investors will still be present in those markets in significant numbers even if the markets are heavily institutional. Market efficiency is not a persuasive enough argument to lead to the conclusion that a mixed institutional-retail marketplace will consistently price issuers' governance and disclosure well enough so that no further regulatory intervention is warranted; at the very least, the U.S. rejected a deferential approach as applied to well-known issuers in Sarbanes-Oxley in favor of even greater intervention on both disclosure and corporate governance.¹³⁷ So, market efficiency alone should not be the basis for deference to foreign regulation. Nor can diversification safely be presumed on the part of retail investors in foreign equities, any more than with respect to domestic stocks.

This suggests that mutual recognition vis-à-vis European and similar regulatory regimes cannot be justified if what we are looking for is true comparability. Ultimately, European-style regulation accepts that institutional investors can effectively fend for themselves with the legal and extra-legal tools at their disposal, and are diversified enough to absorb the remaining risk from lesser transparency. And there aren't enough retail investors to warrant a departure from this expectation. Given that, it makes sense to lighten up on regulatory requirements (e.g., more emphasis on best practices and simple "comply or explain" rules) so as to let issuers experiment with different approaches to corporate governance and disclosure without one-size-fits-all demands. The mandatory risk-reduction devices of Sarbanes-Oxley and similar rules are thus unnecessary. Empirical evidence suggests that the largely institutional market for foreign stocks by and large considers Sarbanes-Oxley (and the enforcement environment it implies) a net burden, especially for smaller companies, if the issuer's home country has a reasonable system of investor protection.¹³⁸

Of course, mutual recognition would still preserve the ability to invoke antifraud protections, through both public (SEC and criminal) and private enforcement. And the interpretation of fraud in U.S. securities law can be notoriously expansive,¹³⁹ especially in public enforcement.

¹³⁷ See John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 J. Econ. Perspectives 91 (2007).

¹³⁸ See Kate Litvak, *Sarbanes-Oxley and the Cross Listing Premium*, 105 Mich. L. Rev. 1857 (2007); JOSEPH D. PIOTROSKI & SURAJ SRINIVASAN, REGULATION AND BONDING: SARBANES-OXLEY AND THE FLOW OF INTERNATIONAL LISTINGS, available at www.ssrn.com/abstract=956987.

¹³⁹ See Donald C. Langevoort, *Schoenbaum Revisited: Limiting the Scope of Antifraud Protection in an Internationalized Securities Marketplace*, 55 Law & Contemp. Probs. 241 (1992).

This is certainly true, but there is reason to doubt that the expansiveness (or willingness to enforce) is quite so strong applied extraterritorially as applied domestically. If antifraud liability were that powerful a substitute for ex ante governance and disclosure regulation, foreign issuers otherwise nervous about U.S. jurisdiction would be unlikely to find mutual recognition particularly attractive in the first place, so that the project would fail for that reason alone. To succeed, mutual recognition must be accompanied by a promise of enforcement limited to true deceit.

We should thus probably acknowledge that mutual recognition increases the risk to less well-diversified retail investors. Perhaps that is reason alone for abandoning the effort, as critics have begun to claim.¹⁴⁰ Mutual recognition, however, is just the continuation of steps that have been underway in U.S. securities law for some time now.¹⁴¹ The decisions to revise the substance of Form 20-F conform to more lax international principles, to allow foreign issuers to avoid quarterly reporting, to permit the use of international accounting standards rather than reconciliation to U.S. GAAP, etc., are all forms of deference to non-U.S. standards, taken with little insistence that the standards for foreign issuers be equal in investor protection to the domestic standards. Even more so, the willingness of U.S. securities regulation to defer entirely to the home country on matters of corporate law (i.e., shareholder voting, fiduciary duties), again without any effort to test for comparability, means that we have long been tolerating the risk of a significant step-down. In many ways, mutual recognition would simply be a candid acknowledgement that there are two very distinct tiers of investor protection in the U.S. – a more rigorous standard for domestic companies, a less rigorous one for foreign companies.¹⁴²

How do we justify this toleration, along with its proposed extension? No justification is needed, of course, for those who believe that the purported rigor of U.S. disclosure rules produces more costs and benefits even for retail investors – i.e., that U.S. regulation is excessive in the first place.¹⁴³ We should probably concede that much of the

¹⁴⁰ See *Reed to SEC: Slow Mutual Recognition*, 40 Sec. Reg. & L. Rep. (BNA) 530 (April 7, 2008).

¹⁴¹ See James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 Colum. L. Rev. 1200 (1999).

¹⁴² See Frederick Tung, *Lost in Translation: From U.S. Charter Competition to Issuer Choice in International Securities Regulation*, 39 Ga. L. Rev. 525, 570-71 (2005).

¹⁴³ Mutual recognition is a highly modified form of what scholars have referred to as “portable reciprocity” – a system in which issuers could freely choose whatever regulatory regime they prefer and be able to raise capital or list their securities solely by

applause for mutual recognition is based on regulatory skepticism alone, coming from those who hope that deregulation with respect to foreign issuers will bring with it pressure to deregulate domestic disclosure as well. But this is hardly an argument that will persuade those inclined toward the opposite view.

What we should look for are benefits that might offset the increased risk. The most often-cited tangible benefit for mutual recognition is that it brings more foreign stocks to U.S. investors' attention. This is a plausible benefit, but probably relatively small – technology is already making such availability possible, and it is just as likely that a meaningful segment of those issuers more reluctant to come to the U.S. because of regulatory burdens is made up of “lemons” whose managers or controlling shareholders covet the private benefits of that control.¹⁴⁴ The trade-offs are not so obvious so as to count as particularly compelling.

Another benefit is entirely political: benefits not to investors but to the financial services industry in New York and other large cities (and indirectly, to their local economies in terms of tax revenue, employment rates, real estate prices and the like) that comes as more global capital markets transactions come to rather than avoid U.S. jurisdiction.¹⁴⁵ There is powerful pressure here, and little doubt that a strong securities industry presence in the U.S. has tangible value. Also, there is an additional benefit to the industry that comes from the reciprocity element to the exercise, opening up foreign markets to greater U.S. presence without new regulatory burdens. There is little more than one can say about trading off some unknown level of retail investor protection to support the industry and gain the valuable externalities beyond the desirability of being candid about it.

reference to that regime. The motivation behind these proposals was skepticism about U.S. securities regulation's overreach. E.g., Stephen J. Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 So. Cal. L. Rev. 903 (1998); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L.J. 2359 (1998). These critics are therefore insistent that the SEC should not condition entry into the U.S. on the home country's regulatory regime being satisfactory to it.

¹⁴⁴ On signaling intentions regarding private benefits of control, see MICHAL BARZUZA, LEMON SIGNALING AND CROSS-LISTINGS (October 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1022282.

¹⁴⁵ Thus, in New York, deregulation in order to increase the attractiveness of U.S. law to foreign issuers is a bipartisan effort. See SUSTAINING NEW YORK'S AND THE U.S.'S GLOBAL FINANCIAL SERVICES LEADERSHIP (2007), available at www.ci.nyc.ny.us/html. This report was prepared under the direction of New York Senator Charles Schumer and New York City Mayor Michael Bloomberg.

If that is all the issue comes down to, then mutual recognition is a close question, defensible perhaps, but far from compelling. Those seeking deregulation for other reasons aside, one might describe its coming in terms of inevitability, but not with enthusiasm. But there is one more point to make. As discussed earlier, it is entirely plausible to see Sarbanes-Oxley and other aspects of U.S. securities regulation as directed not simply at investor protection but as the publicization of the governance of private sources of economic power. It addresses the externalities that excessive corporate risk-taking and other forms of action can create, opening up the internal architecture of the firm to greater sunlight.

If so, then we should not expect U.S. securities law to apply as strictly (especially through SOX-like responsibilities) to foreign firms as domestic ones, because their presence is far greater outside than within. Parmalat may have been a massive financial reporting scandal involving an Italian company traded in the U.S.,¹⁴⁶ but was hardly viewed with the same alarm here as Enron or Worldcom. Most of the collateral damage was felt in Europe, not here. The administrative law-like claim applied to foreign issuers is nowhere near as compelling as applied to large U.S. issuers.

Congress chose not to exempt foreign issuers from Sarbanes-Oxley as a general matter. That would seem inconsistent with my argument that the domestic claim is stronger than in the foreign context, but one shouldn't make too much of this. In the legislative haste, the legislation's proponents probably came to believe that this was good investor protection. Furthermore, the decision not to exempt (and writing specific exemptions would have been complicated) was presumably with the expectation that the SEC (and PCAOB) would be implementing its provisions, and could make adjustments where needed. My point is that with the benefit of time, we understand the uncertainty regarding the benefits to diversified investors more plainly, which in turn makes the stakeholder-regarding aspects more noticeable. It is in this afterglow that a separation between domestic and foreign issuers is more justifiable.

That brings us back to institutionalization. If I am right that there is no strong stakeholder-related reason to apply the strictures of U.S. disclosure and corporate governance rules to foreign issuers, then the

¹⁴⁶ See Guido Ferrarini & Paulo Guidici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, in JOHN ARMOUR & JOSEPH MCCAHERY, EDs., *AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE US* 159 (2006).

question becomes one simply of investor protection, and we are back to the trade-offs described earlier. But perhaps we come to it with a bit less confident in the case for these rules as essential investor protection in an increasingly institutionalized setting. If so, then mutual recognition is a desirable strategy, on balance, so long as the home country's regulation is reasonably responsive to institutional investor interests. This is what sufficiently comparable should mean, not some reference to the inevitably different system generated with the U.S.'s unique, retail investor-oriented political regime. Mutual recognition has a far greater chance of legitimacy to the extent that we are candid about the trade-offs (and our assessment of their magnitude) and if the SEC defines its task in evaluating home country regulation appropriately. Countries in Western Europe, at least, meet that test of regulation regardless of how they do when matched against the U.S. on measures of enforcement intensity.

The vision of the future that I am suggesting, then, is one in which issuer disclosure regulation and enforcement is based more on the issuer's home place of business than where its securities are traded.¹⁴⁷ That is somewhat disorienting in our understanding of the '34 Act, which makes listing on a national securities exchange the principal trigger for regulation in Section 12(b).¹⁴⁸ 12(g) is meant as a back-up, and is a relative latecomer to U.S. securities regulation. Emphasis on 12(b), however, strikes me as unstable. If we lived in a listings-based world, then even a U.S. domestic company could escape the reach of the '34 Act by choosing a London listing (as a handful have actually done). But for reasons that should be clear by now, that would be politically intolerable on any large scale, and 12(g) conveniently serves as a check – enough shareholders and assets keeps the issuer tied to U.S. regulation regardless of where listing or trading takes place.¹⁴⁹ As institutionalization continues, there is good reason to suspect that global securities trading will be increasingly fragmented – many different sites in different countries competing with each other for order flow in the

¹⁴⁷ Merritt Fox has long been a proponent of issuer business location as opposed to trading as the test for jurisdiction, but on different grounds: that allocative efficiency within an economy is enhanced by a good system of disclosure. See Merritt Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 Mich. L. Rev. 696 (1998). He plays down the investor protection need on grounds of market efficiency and portfolio diversification.

¹⁴⁸ A 12(b) model leads very clearly to strong international competition and something resembling issuer choice. See Chris Brummer, *Stock Exchanges and the New Market for Securities Laws*, 75 U. Chi. L. Rev. -- (forthcoming, 2008).

¹⁴⁹ There are also other marketplace forces that tie U.S. based issuers to home. See Tung, *supra*, at 561-66.

same security. Whether the notion of exchange listings as the primary test for whose regulation governs is even sustainable in a fragmented world is unclear: it is doubtful that any given jurisdiction will want to expend the resources necessary to enforce its rules extraterritorially when the benefits of trading are not completely internalized.¹⁵⁰

IV. CONCLUSION

There are three general lessons about the SEC to take from what we have covered here. First, to repeat what should be almost self-evident, the SEC is the retail investor's champion only in a bounded way. There are many spaces in investor protection that it hesitates to enter, not simply because it lacks the resources to do so but because it would be taking on, politically and intellectually, more than it can handle. Subtle sales practices that have led to unsuitable or unbalanced portfolios and too much money spent on unhelpful investment advice are examples that more attention to behavioral economics could help explain, in a way that might allow a coherent policy on retail investor protection to emerge. Instead, the SEC's tendency is simply to confront examples of overreaching with occasional enforcement actions when political demand grows, leaving both investors and the industry unsure of whether there are new regulatory expectations or not, or how long they will last. Globalization is another illustration. The Commission has gradually committed to a two-tier system of disclosure and regulation: one for U.S. issuers, the other for foreign. One has the distinct sense that there are trade-offs being made in an effort to support the U.S. as a desirable location for global capital activity but no well-theorized (much less candid) commitment to that goal.

Perhaps this is explained simply by politics, where candor is always in short supply. However, I suspect that certain of these tensions and inconsistencies are after seventy-five years so far internalized that many of those inside the Commission simply don't recognize them. It is a form of institutional cognitive dissonance. Having said this, I do not want to imply that any such dissonance is entirely a bad thing. The ability to repress inconsistencies – for those on the inside to *feel* that the institution truly is the investors' champion – may be politically very adaptive.¹⁵¹

¹⁵⁰ See Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience*, in *INVESTOR PROTECTION IN EUROPE* (Guido Ferrarini & Eddy Wymeersch, eds., 2006).

¹⁵¹ See Langevoort, *SEC as a Lawmaker*, *supra*, at 1624-25.

The second big take-away point is that the political, social and economic conditions underlying securities regulation are contingent over time. As we have seen, no economy can build a strong retail investment culture without some degree of salesmanship – overcoming the status quo biases that make people hesitate to take on unfamiliar, complex forms of risk, even when it might be good for them. Securities regulation in an early phase of market evolution must be sensitive to this, and regulate with a relatively light touch. But the U.S. is today in a very different place in its capital market evolution, with a high level of habituation in investing, so that the problems associated with retail investor protection then change. The so-called enforcement culture that has gradually developed is no doubt the product of this plus the foreseeable consequence of that success: the securities industry is massively large and diffused culturally and geographically – and whose impact is amplified by a loud and persistent financial media – in ways that make strategies other than enforcement less likely to work.

From this we may gain some insight into what we mean by the elusive phrase “investor confidence” that is so often invoked to justify regulation.¹⁵² On a near-term basis, investor confidence is a mix of sentiment and risk perception, measurable empirically by reference to bid-ask spreads and other cost of capital measures.¹⁵³ Over the longer-term, the test for investor confidence is whether investors might be inclined to flee the securities markets (or particular segments thereof). Regulation responds whenever there is a crisis that raises the possibility of such flight. Chances are, however, that investor confidence is a cognitive construct that has as much to do with habit as anything else. In other words, where retail investors have thoroughly internalized the culture of investing, it takes quite a lot to dislodge it. So far as instilling confidence is concerned (as opposed to simple paternalism, victim compensation or other regulatory goals), the hard work of securities regulation may be less important than when investment cultures are more emergent.

The third and final point links that to globalization. Recent critiques of the SEC and U.S. securities regulation rightly note the importance of comparisons, and do show that other countries have had reasonable success in building capital markets without mimicking the

¹⁵² See, e.g., Lynn Stout, *The Investor Confidence Game*, 68 Brook. L. Rev. 407 (2002)(discussing investors’ adaptive expectations and consequent trust in market institutions).

¹⁵³ See Malcolm Baker & Jeffrey Wurgler, *Investor Sentiment in the Stock Market*, 21 J. Econ. Perspectives 129 (2007).

U.S. That should rightly be humbling. But that success is itself contingent on economic and political conditions in those countries that will change precisely because of that success. The growth of a retail culture (with all the political implications that entails), the attraction of new and more diverse capital markets business, and the predictable stresses and scandals will test those regulatory strategies, and ultimately alter them.

So maybe the SEC at age seventy-five should not seek a makeover to look as attractive as some of the younger regulators around the world, but rather sit back and let them go through the pain that will inevitably accompany their adolescence. If the natural evolution of global securities markets were steadily in the direction of greater retailization, then that would probably be good advice. On the other hand, if institutionalization truly is the future both in the U.S. and around the world, then the layers of retail investor-driven regulation that have accumulated over the last seventy-five years will weigh more heavily going forward.