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

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INTRODUCTION

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 sometimes helps the latter as well. But throughout the SEC's history and culture, the rhetorical stress has been on the plight of average investors, ones who lack investing experience and sophistication so as to need the protection of the securities laws.[1] In response to the appearance of scandal and economic distress, broad popular demand for regulation brought the federal securities laws into being some seventy-five years ago.[2] The subsequent his-

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[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] See Paul G. Mahoney, The Political Economy of the Securities Act of 1933, 30 J. Legal Stud. 1 (2001). As often happens, the facts underlying the perceived scandal

tory of rules, interpretations, and enforcement by the SEC is filled with references to both the need to promote retail-level investor confidence to give depth and liquidity to the nation's financial markets and the desire to level the playing field between the meek and the privileged.[3]

The last thirty years or so have brought a rapid shift toward institutionalization in the financial markets in the United States—in other words, a shift toward 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 (for example, some of the debt markets and the market for start-up venture financing) are almost entirely 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 1980s but now invest trillions of dollars collectively. For instance, although retail investors have certainly suffered massively 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 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

and abuse may have been much more complicated and ambiguous than they first appeared. See Seligman, supra note 1, at 1–100.

[3] See Donald C. Langevoort, Rereading *Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation, 99 Colum. L. Rev. 1319, 1328 (1999) (noting that insider trading enforcement responds in part to imbalances of economic power and status in society).

[4] See Sec. Indus. & Fin. Mkts. Ass'n ("SIFMA"), 2007 Fact Book 65 (Charles M. Bartlett, Jr. ed., 2007) (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.

[5] See Steven L. Schwarcz, Essay, Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown, 93 Minn. L. Rev. 373, 375–79 (2008) (discussing the causes of the subprime financial crisis).

[6] Brian G. Cartwright, General Counsel, Sec. & Exch. Comm'n, The Future of Securities Regulation, Speech at the University of Pennsylvania Law School Institute for

address. Hence, I intend to be very selective in what follows and focus mainly on the role of the SEC as a seventy-five-year-old agency in a capital marketplace very different from that of the 1930s. A baseline question about the future of financial regulation in the United States is whether the SEC, with such a long and weighty legacy of lawmaking from a time when public markets were essentially 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 subject areas: the regulation of the securities markets and the securities industry, and the regulation of corporate issuers and information about issuers.[7] One of my main claims is that institutionalization plays out very differently in these two domains, so that calls for change should differentiate more carefully between them. Part I will turn entirely to the first subject area and ask whether there is a coherent theory or approach to retail investor protection in today's marketplace, either in terms of enforcement intensity or rulemaking. Here I will consider two very different contemporary challenges to the SEC's orthodoxy: first, the emergence of the British "light touch" model to securities industry regulation, which favors informal suasion to heavy-handed enforcement, and second, the expansion of knowledge about consumer and investor behavior from research in behavioral economics. Light touch, I argue, maps poorly onto the SEC's regulation of the securities industry because of the dramatically different size, scope, and state of development of that industry in the United States as compared with that in the United King-

Law and Economics (Oct. 24, 2007) (transcript available at http://www.sec.gov/news/speech/2007/spch102407bgc.htm). Readers familiar with Cartwright's speech 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. I agree and prefer the more common "institutionalization." This theme and some of the same subjects are also taken up in Steven M. Davidoff, Paradigm Shift: Federal Securities Regulation in the New Millennium, 2 Brook. J. Corp. Fin. & Com. L. 339, 340 (2008).

[7] Historically, it is unclear whether this second objective was simply subsidiary to the first (in other words, that if issuers made full disclosure, markets would be more difficult to manipulate) or whether Congress had a more aggressive corporate governance agenda. For a view inclined toward the latter, see Cynthia A. Williams, The Securities and Exchange Commission and Corporate Social Transparency, 112 Harv. L. Rev. 1197, 1237 (1999). Whatever Congress' original intent, the corporate regulation portion of the securities law has surely grown to rival market regulation.

dom. And the lessons of behavioral economics are just too disorienting for the Commission to deal with coherently, in light of the implicit political compromise that allows the industry substantial room to induce investor demand for securities through aggressive sales and marketing. Part II then will move to the institutional marketplace for issuer securities and engage in a thought experiment about whether or not markets that have no appreciable direct retail participation should properly be governed as "antifraud only," as many people assume. I will 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 issuer disclosure regulation, that would substitute for the public ones we observe today. Finally, Part III will examine whether the SEC's regulatory orthodoxy is sufficiently stable as markets become not only institutional, but also global. I suggest, contrary to what many believe, that globalization leads *away* from listings-based exercise of regulatory jurisdiction over issuer disclosure, and place the SEC's recent initiatives toward mutual recognition in this context.

While these topics may seem quite disparate, there is a unifying theme. It stems from my long-standing interest in studying the behavior of the SEC—why and when it acts as it does, and what self-imposed and externally mandated rules it follows.[8] Behind its public face, the SEC is a political entity, balancing its internal vision of investor protection against a 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 which 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 that might be

[8] See, e.g., Langevoort, supra note 3, at 1328–40 (analyzing the SEC's approach to the regulation of insider trading); Donald C. Langevoort, The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty, 84 Wash. U. L. Rev. 1591, 1592–93 (2006);. Many others have explored these questions as well. See, 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, 559–65 (2001); Jonathan R. Macey, Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty, 15 Cardozo L. Rev. 909, 921–48 (1994); A.C. Pritchard, The SEC at 70: Time for Retirement?, 80 Notre Dame L. Rev. 1073, 1077–92 (2005).

more sympathetic to the business community.[9] In the seventy-five years since, the SEC 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 influence, such as the adverse publicity 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 both career interests and information deficits[11] that affect SEC activity.

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 within these bounds has long been a matter of divisive professional and scholarly debate, and the limitations are visible enough to careful observers. The recent financial crises have exposed some of these flaws to greater public scrutiny, leading to serious questions about the Commission's future.[12] But any reform efforts must build from a realistic understanding of the Commission's institutional capacity. By looking closely at what motivates and constrains the SEC's behavior in today's complex and changing securities markets, we can better understand both its identity and its political ecology.

[9] See Seligman, supra note 1, at 95–99.

[10] See Anne M. Khademian, The Securities and Exchange Commission: A Small Regulatory Agency with a Gargantuan Challenge, 62 Pub. Admin. Rev. 515, 519–22 (2002).

[11] This includes cognitive limitations. See Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 Stan. L. Rev. 1 (2003); Langevoort, supra note 8, at 1608–12.

[12] See, e.g., Michael Lewis & David Einhorn, The End of the Financial World as We Know It, N.Y. Times, Jan. 4, 2009, at WK9 (criticizing the SEC as politically unwilling to challenge Wall Street's status quo). On the redesign question, see John C. Coffee, Jr. & Hillary A. Sale, Redesigning the SEC: Does the Treasury Have a Better Idea?, 95 Va. L. Rev. 707 (2009).

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) have grown steadily over the last few 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-1930s to allow the industry to regulate itself as a first line of control, under SEC supervision.[13] Hence, much of the conduct regulation here is by self-regulatory organizations (most importantly, the Financial Industry Regulatory Authority ("FINRA")), rather than the SEC.[14] 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 area of mutual funds, the SEC's role is more dominant, though FINRA regulates fund distribution practices as well. There is no self-regulatory organization ("SRO") for investment advisors, but here, since 1996, there has been a division of primary supervisory responsibility between the SEC and state securities regulators based on the size of the advisor.[15] In other areas, such as 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. As a result, even describing (much less evaluating) SEC regulation in the retail sector is both complicated and context-specific.

[13] See James D. Cox et al., Securities Regulation: Cases and Materials 16–17, 1021–23 (5th ed. 2006).

[14] 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. See FINRA, About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/index/htm (last visited Mar. 7, 2009).

[15] See Cox et al., supra note 13, at 1081–82.

In the face of this complexity, an overriding question is how well the SEC makes 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, this inquiry forces us to confront serious gaps in our knowledge. Three questions loom. First, what do we even mean by industry misbehavior?[16] It is not clear that we have a workable definition of when a broker or advisor crosses the line, short of abject fraud. Second, how much misbehavior exists in the industry? We can count investor lawsuits and complaints with regulators, but this will 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 evidence of abuse, they will not always take action. Conversely, not all suits and complaints have merit, so these numbers may not accurately reflect industry misbehavior. Third, what is the causal relationship between regulatory enforcement and good or bad behavior? There are competitive and reputational constraints on misbehavior such that it is hard to know how tightly coupled regulatory threats and industry behavior truly are, regardless of intensity.

This profound ambiguity means that perceptions of industry abuse are socially constructed and will vary over time. The demand for regulation in this area will spike periodically as large scandals appear,[17] and the SEC will respond based on meager base-rate evidence.[18]

[16] 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 1032–35, 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.

[17] See Stuart Banner, What Causes New Securities Regulation? 300 Years of Evidence, 75 Wash. U. L.Q. 849, 850–51 (1997) (arguing that individuals are more receptive to securities regulation following market crashes when concerns over market manipulation are high).

[18] See Choi & Pritchard, supra note 11, at 25; Gregory Mitchell, Case Studies, Counterfactuals, and Causal Explanations, 152 U. Pa. L. Rev. 1517, 1519–25, 1542–46 (2004).

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.[19] Recent calls for reform of securities regulation in the United States have targeted this concern, raising doubts about cost-effectiveness and whether such regulation unduly burdens global competitiveness.[20] 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."[21] Thus, the argument concludes that the SEC should learn from the FSA and behave similarly.

Light touch is a term of art used 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 the large literature on so-called "new governance" strategies for regulation that seek to enlist the cooperation of the regulated community so as to overcome the inevitable informational disadvantage that regulators have when dealing with rapidly changing markets.[22] The basic idea is to let regulated entities experiment with compliance practices without a one-size-fits-all command, so long as outcomes satisfy the articulated principles.

[19] "Enforcement intensity" in securities regulation has received a great deal of attention as a matter of comparative law. See, e.g., Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications, 24 Yale. J. on Reg. 253 (2007); Howell E. Jackson & Mark J. Roe, Public and Private Enforcement of Securities Laws: Resource-Based Evidence (Harvard Pub. Law, Working Paper No. 08-28, 2008), available at http://ssrn.com/abstract=1000086. 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, Jr., Law and the Market: The Impact of Enforcement, 156 U. Pa. L. Rev. 229 (2007). For a response, see Eilis Ferran, Capital Market Competitiveness and Enforcement (Apr. 30, 2008) (unpublished manuscript, available at http://ssrn.com/abstract=1127245).

[20] E.g., Charles E. Schumer & Michael R. Bloomberg, To Save New York, Learn from London, Wall St. J., Nov. 1, 2006, at A18.

[21] For a history of the FSA and a suggestion that the single regulator model is a useful, but not necessarily ideal, model for countries worldwide, see Eilis Ferran, Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model, 28 Brook. J. Int'l L. 257, 259 (2003).

[22] See, e.g., Cristie L. Ford, New Governance, Compliance, and Principles-Based Securities Regulation, 45 Am. Bus. L.J. 1, 60 (2008).

Shortcomings are remediated, but not necessarily punished. The FSA touts this as a substantial competitive advantage over the way the SEC operates.

We have to be careful in evaluating the claim that the SEC should be reformed in line with the FSA's image, for this claim is more complex than it first appears. There are, after all, many different aspects of securities regulation (for example, consumer protection versus risk regulation or back-office controls). That the FSA performs some of these aspects well would not necessarily mean that its approach works across the board. In addition, we do not know for sure how well it does in any domain. Although London has done well in the first years of the FSA's existence, the FSA is a relatively new agency, and it is hardly clear whether the FSA caused that success. Indeed, the FSA has its critics, especially as the recent financial troubles have caused substantial losses in the United Kingdom.[23]

Thus, there are open empirical questions here, including whether the systems in operation are really as different as publicly touted and whether the FSA's touch might be heavier in the domain we are considering, retail investor protection, than in other areas. 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.[24] Hence, for now, let us simply assume both that there is a clear distinction and that the light-touch approach has thus far worked well in the United Kingdom. The important questions would be why and whether the advantage could be transplantable back to the United States.[25]

[23] See, e.g., FSA at Bay, The Economist, Mar. 18, 2009, http://www.economist.com/world/britain/displaystory.cfm?story_id=13315523.

[24] See Financial Services Authority, FSA Annual Report 2006/07, at 28 (June 21, 2007), available at http://www.fsa.gov.uk. For a discussion, see Julia Black et al., Making a Success of Principles-based Regulation, Law & Fin. Mkts. Rev., May 2007, at 191, 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 note 22, at 11–26.

[25] 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, e.g., Daniel Berkowitz et al., The Transplant Effect, 51 Am. J. Comp. L. 163 (2003).

Conventional economic analysis of these issues starts by assuming that the securities industry and its members are wealth maximizing and opportunistic but that opportunism is constrained by a mix of legal and nonlegal incentives (for example, reputation, as noted earlier, or competitive constraints). In turn, the regulator's legal strategy can be a mix of enforcement sanctions and less formal efforts at suasion. Such a mix aims at optimal deterrence, that is, the right balance between probability of detection and amount of sanction in light of the expected benefits of cheating.

Within this framework, there are quite a number of possible explanations for why light touch might work as applied to retail securities. These explanations fall into two main clusters. A low intensity enforcement strategy works if (a) nonlegal sanctions are already compelling enough that little additional regulation is necessary, and/or (b) informal regulatory suasion is potent enough to make subsequent enforcement unnecessary. As to (a), one possibility is that the local culture tolerates little professional opportunism, meaning that stockbrokers usually behave well without the need for strong regulatory threat. If so, the reputational harm from cheating that is detected will be high because those in the industry will be culturally sensitive to criticism, and the sanctions on transgressions imposed by investors will be severe because they generate greater fear or anger.[26] As to (b), low enforcement might succeed when surveillance and monitoring are sufficiently thorough such 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.[27] Imagine an industry that is both fairly concentrated and operates on a relatively small scale. A regulator

[26] Along these lines, we could ask whether British stockbrokers might be culturally inclined to greater honesty and fairness 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 United Kingdom and the United States along this dimension. For a sampling of this literature, see, for example, Amir N. Licht, The Mother of All Path Dependencies: Toward a Cross-Cultural Theory of Corporate Governance Systems, 26 Del. J. Corp. L. 147 (2001) and Shalom H. Schwartz, A Theory of Cultural Values and Some Implications for Work, 48 Applied Psychol. Int'l Rev. 23 (1999). Suffice it to say that, were there such a cultural difference, it would simply strengthen my skepticism about the transplantability of the U.K. regulatory approach.

[27] See Jackson, supra note 19, at 264.

can exercise informal power relatively easily by being geographically and socially proximate to the regulated community and holding leaders' reputations "hostage" to enforce good behavior; such informal power might manifest itself in a regulator's willingness to criticize leaders and their firms for any shortcomings.[28] Research indicates that more closely interconnected social networks generate mimetic behavior because tighter networks facilitate the transmission of both ideas and norms.[29] In turn, social networks correlate with geographic proximity.[30] Therefore, to the extent that there are greater social network affinities between the regulator and the regulated, informal suasion should be more potent.

Reputational effects will also have greater bite with respect to an industry that is seeking to grow out of its infancy.[31] Behavioral economics (and common observation) teaches that gaining new customers is harder than retaining existing ones, even though neither task is necessarily easy.[32] Reputational harm makes it particularly hard to convince those accustomed to acting in a certain way to abandon the status quo. Potential retail investors looking to invest actively will choose not to if given cause to question a particular

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

[29] For a literature review relating this to finance, see David Hirshleifer & Siew Hong Teoh, Thought and Behavior Contagion in Capital Markets, *in Handbook of Financial Markets: Dynamics and Evolution* 1, 2 (Thorsten Hens & Klaus Reiner Schenk-Hoppe, eds., 2009). On options backdating, see John Bizjak et al., Option Backdating and Board Interlocks (Feb. 1, 2007) (unpublished manuscript, available at http://ssrn.com/abstract=946787). For a classic article on how poison pills spread through interlocks among directors, see Gerald F. Davis, Agents Without Principles? The Spread of the Poison Pill Through the Intercorporate Network, 36 Admin. Sci. Q. 583 (1991).

[30] There is abundant literature in economics on this correlation. See, e.g., David B. Audretsch & Maryann P. Feldman, R&D Spillovers and the Geography of Innovation and Production, 86 Am. Econ. Rev. 630, 637 (1996).

[31] 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 L. Liebman & Curtis J. Milhaupt, Reputational Sanctions in China's Securities Market, 108 Colum. L. Rev. 929, 947–59 (2008).

[32] The classic account on this subject is William Samuelson & Richard Zeckhauser, Status Quo Bias in Decision Making, 1 J. Risk & Uncertainty 7 (1988) (reporting the results of decision-making experiments demonstrating that individuals prefer the status quo).

firm or the industry as a whole. By hypothesis, those firms in a growing industry should be more sensitive to the risk of informal sanctions, such as bad publicity, than those firms in a mature one, especially when the service provided by the firm requires a high level of trust.[33]

Nonlegal sanctions and informal regulatory suasion may well explain the assumed success of a light-touch approach to retail investor services regulation in the United Kingdom. The retail industry there is growing, but small,[34] and still relatively concentrated. By one count, the FSA regulates approximately 1,000 firms that deal or advise in securities, with slightly more than 8,000 individuals authorized to conduct customer trading in securities as of early 2005.[35] As John Armour and David Skeel highlight in their study of comparative takeover regulation, the British regulatory and financial services communities interact repeatedly with each other, which in turn allows informal pressure to be used more effectively.[36] And, because the engrained popular habits of conservative (and government-sponsored) savings, broad public distrust of retail service providers would be particularly debilitating to the growth of the retail segment in Europe. Regulators thus have a great deal of leverage; their quiet threats would naturally be more potent in these circumstances.

Now, however, try transplanting this system to the United States, which differs dramatically along many dimensions.[37] First, the size

[33] No doubt there is a cultural dimension to willingness to trust that relates to the propensity to invest. See Luigi Guiso et al., Trusting the Stock Market, 63 J. Fin. 2557 (2008) (studying the effects of a general lack of trust on market participation). But, as developed more fully below, this trust is subject to influence and manipulation as well.

[34] For a thorough assessment of the status of retail investor participation in the European Union and proposals for promoting a stronger equity culture, with specific attention to the United Kingdom, 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).

[35] See Int'l Fin. Servs., Securities Dealing: City Business Series 14–15 (2007), available at http://www.ifsl.org.uk/output/ReportItem.aspx?NewsID=522006. 2006 operating profits of U.K. securities dealers (which includes activities well beyond retail) were £3.4 billion. Id. at 15.

[36] 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).

[37] In terms of total stock market capitalization, the United States is roughly seven times larger. Regulator expenditures for securities regulation for the two countries

and scope of the retail securities industry is far larger. In 2006, there were more than 5,000 firms that were members of the NASD (now FINRA), with some 658,000 registered representatives.[38] Public customers had some 111 million accounts at registered securities firms.[39] And that is simply the broker-dealer industry. There are also around 10,000 investment advisers registered with the SEC, whose work often blurs with that of broker-dealers.[40]

Because of this size and dispersion, there is likely a far greater degree of cultural separation and distance between the business and governmental communities. 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.[41] Washington and New York are culturally distinct, even though closely tied, and retail securities industry leaders are commonly based in cities far from either one. Though a handful of 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 United States, it appears, regulators and business people do not share social and geographic space as frequently as in the United Kingdom. If so, quiet suasion is less likely to be heard.

Moreover, the retail investment market is relatively mature in the United States, with well-engrained habits of retail investors that by now are hard to dislodge. There is a multiplier effect oper-

are not terribly different when adjusted per dollar of market capitalization; indeed, the United Kingdom spends a bit more. See Jackson, supra note 19, 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.

[38] See SIFMA, supra note 4, at 4. The pre-tax profitability of this sector was roughly $33 billion. Id. at 27.

[39] Id. at 66.

[40] See RAND Inst. for Civ. Just., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers 35–36 (2008), available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

[41] See Mark L. DeFond et al., The Geography of Auditor Independence and SEC Enforcement 1–2 (May 13, 2008) (unpublished manuscript, available at http://ssrn.com/abstract=1132885) (citing evidence that "managers located closer to SEC Regional Offices have a greater awareness of the SEC's enforcement and disciplinary activities, which . . . leads to better reporting"); Simi Kedia & Shiva Rajgopal, Geography and the Incidence of Financial Misreporting 26 (July 9, 2007) (unpublished manuscript, available at http://ssrn.com/abstract=1121453).

ating here: the size and penetration of the retail securities industry brings with it attention from the financial and general media that support a culture of investing. In all likelihood, the level of scandal required 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 much lower than it would be if the retail industry were at an earlier stage of marketplace development where there was no pattern of customer loyalty.

What all this suggests, then, is that differing economic and regulatory conditions themselves may explain the relative success of a light touch in the United Kingdom in a way that could not be transplanted to the United States.[42] If so, the critics' call for the SEC to follow the FSA here and simply "lighten up" is misplaced. Moreover, any competitive advantage the United Kingdom 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 nonlegal forces are likely to weaken, and the conditions the FSA faces will start to resemble those the SEC has faced for many decades now.

This account leads to an important difference in political ecology. In the United Kingdom, the current retail investor base is small, and thus retail investor protection issues have less political salience. Media attention to these issues is presumably less as compared to other retail financial services areas (for example, banking and insurance) and large-scale institutional investor issues (for example, pension retirement plans). 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 this Article addresses in Part II—because of the greater capacity for investor self-help, and so the FSA's natural regulatory inclination meshes with lower

[42] 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. On the latter point, judicial protection of business "rights" as against administrative control gives the industry more leverage to negotiate with the regulator.

political demand to produce a comfortably low level of regulatory intensity in the retail area as well.[43]

Furthermore, to the extent that the government wants to encourage growth in the retail sector, it may be inclined to keep the 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 (for example, 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 United Kingdom 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 United Kingdom is now a world leader in many segments of global finance. Once again, however, this success is contingent. Any significant growth in the British retail sector would change the political equilibrium over time to more resemble that found in the United States such that the stresses of investor losses and the scent of scandal would weigh more heavily than they do currently.

My argument here is not that the SEC's (or United States') greater enforcement emphasis is better, much less optimal; it is 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.[44] 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 inves-

[43] See John Armour, Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment (European Corporate Governance Institute, Working Paper No. 106/2008, 2008), available at http://ssrn.com/abstract=1133542. Consistent with the social networks approach, Armour suggests that as the United Kingdom attracts more foreign institutional investors to its markets, the ability to rely on reputational sanctions will be strained and more conventional enforcement techniques used. Id. at 9–11.

[44] See Ford, supra note 22.

tor sentiment is high. Deference to experimentalism works only when there is a credible threat that bad faith will be discovered and punished.[45] In many ways, the system of self-regulation implemented in the United States in the 1930s 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.[46] The effect this has had on making the industry more transparent or cooperative is unclear, but it was a reaction to repeated opportunism.

I am also not suggesting that the enforcement intensity of the SEC and its self-regulatory affiliates consistently hits its mark. We return 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 entirely possible that even with occasional mega-cases—for example, the $1.4 billion global settlement growing out of allegations of analyst conflicts of interest[47]—and thousands of smaller enforcement cases and arbitral awards, both the probability of detection and the magnitude of sanction remain 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, massively amplified by recent events.[48] 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

[45] Id. at 32–33.

[46] 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, 1348 (2004).

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

[48] See Lewis & Einhorn, supra note 12.

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, and blunts calls for more intrusive regulation. The SEC becomes an enabler of malfeasance, either innocently (cognitive blindness to its own limitations) or deliberately (agency capture).[49]

There is too vast a knowledge gap to be entirely sure how far from optimal SEC enforcement is, or even in what direction any shortfall occurs. But the repetition of securities industry scandals every few years—analyst conflicts, mutual fund late timing, credit ratings, sub-prime sales tactics, and the massive "Ponzi scheme" engineered by Bernard Madoff, all just in the last decade—is ample cause for concern that the deterrence calculus is systematically too low, as industry critics insistently contend. If so, however, this 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 comparative advantage. Of course, there is the contrary possibility 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.[50] For this to be so, however, we have to assume that reputation and other nonlegal 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 imagination. These arguments are familiar enough,[51] but increasingly far from persuasive.

[49] 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 Amitai Aviram, Counter-Cyclical Enforcement of Corporate Law, 25 Yale J. on Reg. 1, 12–14 (2008).

[50] For a discussion of the value of investors' emotional demands, see Peter H. Huang, Regulating Irrational Exuberance and Anxiety in Securities Markets, *in The Law and Economics of Irrational Behavior* 501 (Francesco Parisi & Vernon L. Smith eds., 2005).

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

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. 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 here, in the British style, would be a poor fit given the nature, size, and scope of the industry as it exists today in the United States. To pursue this question further, however, we need to consider whether the SEC is even working with a sufficiently accurate model of investor behavior to assess either the risk or nature of that opportunism.

B. Behavioral Economics, Opportunism and the Centrality of Salesmanship

The foregoing poses an interesting, and thus far unexplored, question: does the challenge facing securities regulation vary depending on how deeply engrained the motivation to invest is, either individually or culturally, and if so, how? As noted, it is entirely possible that the task faced by the FSA as the United Kingdom tries to build a retail investment culture differs considerably from what the SEC faces with a retail culture that is already deeply engrained. This is worth more thought.

The principles applied to the retail securities industry are easy enough to articulate in the abstract: fair dealing, just and equitable conduct, and full disclosure. But each of these is sufficiently capacious to have many possible meanings in context and to 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.[52] This research goes under the general headings of behav-

[52] For an earlier effort in this direction, see, for example, Donald C. Langevoort, Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and 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. See, e.g., Troy A. Paredes, Blinded by the Light: Information Overload and its Consequences for Securities Regulation, 81 Wash. U. L.Q. 417, 418–19 (2003).

ioral economics or behavioral finance.[53] 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 stemming from incomplete information, creating an incentive for sellers to volunteer (and vouch for the accuracy of) information in their possession where such disclosure would lower the compensation the buyer would 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.

The SEC has long rejected this hypothesis, reasonably claiming that while some number of investors might conform to the rational actor model, others—naïve and unsophisticated—do not and hence 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 decisionmaking process that investors employ. The SEC's habitual use of the disclosure remedy for purposes of retail investor protection, for instance, rests on the unexamined (and often dubious) premise that investors who fall sufficiently short of the rational actor model to require paternalistic intervention will necessarily process the information rationally once it is delivered to them. Conversely, it also assumes that the capacity to process information means that it will be processed well.

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 bi-

[53] For a survey of the voluminous behavioral finance literature, see generally David Hirshleifer, Investor Psychology and Asset Pricing, 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; as to 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.

ases, that is, systematic departures from Bayesian rationality. Unfortunately, from a theoretical perspective, heuristics and biases are not so automatic that all people can be said to exhibit them in all circumstances. They are simply ways of thinking and deciding that appear in laboratory experiments and field studies with statistically significant frequency. As applied to investor decisionmaking, this methodological limitation led early on to doubts that the laboratory findings necessarily tracked behavior by people in real-life financial market settings, which are characterized by high stakes, the opportunity to learn from experience, and the like.[54] But substantial progress has occurred to overcome these doubts. 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 (for instance, MBA students as proxies for relatively sophisticated investors[55]). Outside the laboratory, large data sets have been collected to examine the actual behaviors of retail investors—for example, one of online customers of a major U.S. brokerage

[54] See Richard A. Posner, Rational Choice, Behavioral Economics, and the Law, 50 Stan. L. Rev. 1551, 1570–71 (1998); see also Richard A. Epstein, Behavioral Economics: Human Errors and Market Corrections, 73 U. Chi. L. Rev. 111, 111–14 (2006); Alan Schwartz, How Much Irrationality Does the Market Permit?, 37 J. Legal Stud. 131, 132 (2008). Interestingly, Judge Posner recently posted on his website an assessment of the recent sub-prime debacle that says: "Studies in cognitive and social psychology have identified deep causes for the overoptimism, wishful thinking, herd behavior, short memory, complacency, and naive extrapolation that generate speculative bubbles—and that require heavy doses of reality to hold in check." Posting of Richard Posner to The Becker-Posner Blog, http://www.becker-posner-blog.com/archives/2007/08/against_bailout.html (Aug. 19, 2007). Even though Posner's claim was an argument 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 D. Levitt & John A. List, What Do Laboratory Experiments Measuring Social Preferences Reveal About the Real World?, 21 J. Econ. Perspectives 153 (2007).

[55] See, e.g., Don A. Moore et al., Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions, 79 Org. Behav. & Hum. Decision Processes 95, 100–01 (1999). For a discussion of the extensive experimental literature on asset "bubbles," see generally Erik F. Gerding, Laws Against Bubbles: An Experimental-Asset-Market Approach to Analyzing Financial Regulation, 2007 Wis. L. Rev. 977, 979–83 (2007).

firm[56] and another dealing with Finnish investor activity[57]—in order to test decisionmaking in real life.[58] In the mutual fund area, a great deal of data regarding fund flows permit behavioral predictions to be tested as well.[59]

As a general matter, these studies support the idea that investors act less than fully rationally with enough frequency to cause concern. But base-rates remain a problem: how often and to what degree is highly situational. That the problem may be fairly large is bolstered by an observation that economists (including the most orthodox) have made 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 estimated the capitalized amount spent on investment advice (retail and institutional) to be at least 10% of the entire current market capitalization.[60] The cause for concern

[56] Brad M. Barber & Terrance Odean, Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors, 55 J. Fin. 773, 774 (2000).

[57] 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, 44 (2000).

[58] See Lauren E. Willis, Against Financial-Literacy Education, 94 Iowa L. Rev. 197, 204–07 (2008). A good overview of field study research in behavioral economics can be found in Stefano DellaVigna, Psychology and Economics: Evidence from the Field 1–3 (Nat'l Bureau of Econ. Research, Working Paper No. 13420, 2007), available at http://www.nber.org/papers/w13420. In a particularly noteworthy field study, a South African financial services firm performed 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 (Econ. Growth Ctr., Discussion Paper No. 918, 2005), available at http://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 J. Cooper et al., Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows, 60 J. Fin. 2825 (2005).

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

[60] See Kenneth R. French, Presidential Address: The Cost of Active Investing, 63 J. Fin. 1537, 1538 (2008). For a similarly dramatic claim about the role of marketing and advertising in economic activity, see Donald McCloskey & Arjo Klamer, One Quarter of GDP is Persuasion, 85 Am. Econ. Rev. (Papers & Proc.) 191, 192–93 (1995).

about this flows from research on market efficiency, a subject this Article pursues in the next Part.[61] If markets are semi-strong efficient, then investors should not pay to try to beat the market. Even if one doubts whether the market displays that kind of efficiency,[62] the evidence suggests 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 (like 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 all of the empirical and experimental literature or to catalog all of the various heuristics and biases that might explain investor decisions. That has been done amply elsewhere.[63] The question regarding the SEC is whether it should assume the task (directly or with 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. To many, investor "foolishness" is not a regulatory concern per se, and the securities laws do not grant the Commission plenary authority to remedy poor investor choice. While that is true, the ideological question becomes much harder when we observe that investor weakness can be exploited for profit, so that some unknown portion of the poor choice is in all likelihood in-

[61] Retail investors need to be careful regarding the implications of efficiency because they are often insufficiently diversified. See Howell E. 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. 671, 672–73 (2003).

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

[63] See, e.g., Nicholas Barberis & Richard Thaler, A Survey of Behavioral Finance, *in* 1B Handbook of the Economics of Finance (George M. Constantinides et al. eds., 2003). A recent report for Britain's FSA contains a good overview of retail investor susceptibility to cognitive biases 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 2–4 (2008), available at http://www.fsa.gov.uk/pubs/consumer-research/crpr69.pdf.

duced. Firms respond strategically to evidence of cognitive bias.[64] Hence, much of the behavioral research focuses on the opportunities for manipulation and persuasion, assuming that firms understand the psychology 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 the 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, for example, people often simplify by focusing entirely on two or three salient attributes of the decision.[65] The less able they are to frame the decision in narrow terms, the more often the outcome is one of indecision or procrastination. 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 savings through a preferred plan is the default from which they must opt out, rather than something they must choose.[66]

This tendency toward inaction could pose a severe problem for the individual and the economy if it leads to a level of investment

[64] In many ways, this is the essence of advertising and marketing. See, e.g., Langevoort, supra note 52 at 652–55; Sendhil Mullainathan et al., Coarse Thinking and Persuasion, 123 Q.J. Econ. 577, 578 (2008). On persuasion tactics in the context of selling cigarettes, see Jon D. Hanson & Douglas A. Kysar, Taking Behavioralism Seriously: The Problem of Market Manipulation, 74 N.Y.U. L. Rev. 630, 732–33 (1999). The field of strategic response to consumer bias is referred to as "behavioral industrial organization."

[65] Daniel Read et al., Choice Bracketing, 19 J. Risk & Uncertainty 171, 171–73 (1999). This relates to 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, e.g., Richard H. Thaler, Anomalies: Saving, Fungibility, and Mental Accounts, 4 J. Econ. Perspectives 193, 194–95 (1990).

[66] See Richard H. Thaler & Shlomo Benartzi, Save More Tomorrow™: Using Behavioral Economics to Increase Employee Saving, 112 J. Pol. Econ. S164, S168–69 (2004).

that is less than it should be.[67] But most cognitive biases are contingent and situational such that decisions can be reframed to make risky 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 Tversky and Kahneman's famous prospect theory.[68] Emphasizing certain information can alter perception of gains, losses, and risk so as to change the decision outcome.

Sellers of investment products take advantage of this. 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 exploits investors' tendencies 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 (for example, 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 a part of the engine of economic growth. Moreover, if we assume that the natural product of cognitive bias is inaction, and hence under-investment, sellers who overcome this add value both individually and socially.

[67] A good example of this phenomenon is the significant underutilization of annuities in retirement. See generally Thomas Davidoff et al., Annuities and Individual Welfare, 95 Am. Econ. Rev. 1573, 1574–75 (2005). For behavioral explanations, see generally Jeffrey R. Brown et al., Why Don't People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle 2–4 (Nat'l Bureau of Econ. Research, Working Paper No. 13748, 2008), available at http://www.nber.org/papers/w13748 and Wei-Yin Hu & Jason S. Scott, Behavioral Obstacles to the Annuity Market 2 (Mar. 2007) (unpublished manuscript, available at http://ssrn.com/abstract=978246).

[68] Amos Tversky & Daniel Kahneman, The Framing of Decisions and the Psychology of Choice, 211 Science 453, 453–54 (1981).

[69] See Sendil Mullainthanan & Andrei Shleifer, Persuasion in Finance 2–5 (Oct. 2005) (unpublished manuscript, available at http://ssrn.com/abstract=864686).

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 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 becomes greater. Complex products that have become widespread in the retail sector, like equity index annuities, can only be sold by intensive, time-consuming sales efforts. 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 is 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, is directed at this, and the SEC has heavy-handed advertising controls for in-

[70] See Langevoort, supra note 52. 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 generally Tamar Frankel, Trust and Honesty: America's Business Culture at a Crossroad (2006) and Claire A. Hill & Erin Ann 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. 58,022, 73 Fed. Reg. 37,752 (2008), *reprinted in* [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,233, at 86,699 (June 25, 2008).

[72] See Daniel Bergstresser et al., Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry 2–3 (Sept. 26, 2007) (unpublished manuscript, available at http://ssrn.com/abstract=616981).

vestment advisers.[73] The regulators are plainly fighting battles, but it is not clear that they had a coherent or consistent approach to their strategy or have chosen a level of intensity for their efforts equal to the challenges that behavioral economics reveals.

The insights of behavioral economics are simply too disorienting and daunting for the SEC to embrace them easily. Consider the role of disclosure. Disclosure works in the sales practice area to the extent that it is salient enough to be visible in the dense informational environment the investor is navigating. But recall that people simplify by narrowing the product attributes on which they will make their choice; if the disclosure relates to a nonpreferred 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 permit 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 by segmenting their products into ones with different costs (front end loads, back end loads, etc.), varying these costs for some investors but not for others.[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 the more sophisticated.

[73] See James D. Cox et al., supra 13, at 1088.

[74] See John C. Coates IV & R. Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, 33 J. Corp. L. 151, 153 (2007).

[75] For a review, see Paul G. Mahoney, Manager-Investor Conflicts in Mutual Funds, 18 J. Econ. Perspectives 161, 164–65 (2004).

I will leave to others further evaluation of the details 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, in theory so as to facilitate fair rather than unfair comparisons, the rules feed a notorious psychological bias in the form of trend chasing. Retail investors show a significant disposition to believe that past good or bad performance implies a similar future, when, in reality, it does not.[76] Nor does the SEC insist on identification of the fund's historic "alpha," that is, 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 such a requirement would reveal is often discouraging. 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] As noted, 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 post hoc and under-theorized, with the SEC sometimes challenging the nondisclosure of conflicts as false and misleading, even when there was no applicable disclosure rule or when the company complied with the minimal obligation then in

[76] E.g., Prem C. Jain & Joanna Shuang Wu, Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows, 55 J. Fin. 937, 939 (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. See, e.g., Matthew R. Morey, The Kiss of Death: A 5-Star Morningstar Mutual Fund Rating?, 3 J. Inv. Mgmt. 41, 44–45 (2005).

[77] See Laurent Barras et al., False Discoveries in Mutual Fund Performance: Measuring Luck in Estimated Alphas 2 (Swiss Fin. Inst. Research Paper No. 08-18, 2008), available at http://ssrn.com/abstract=869748.

effect. Lurking behind these reactive challenges 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 the disclosures address possible firm-wide conflicts rather than conflicts specific to the broker in question.[78] Indeed, if the disclosures 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 of 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 of disclosure effectiveness. And to be sure, disclosure can have positive effects even when processed poorly by a large segment of investors. Reaction by more careful investors alone 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 enables the culture of investing.[81] There is an important historical point here that ties

[78] See Langevoort, supra note 52, at 671–73, 692–95.

[79] See Daylian M. Cain et al., The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest, 34 J. Legal Stud. 1, 5–7 (2005).

[80] See note 54 supra. However, there are recognized limits on this cleansing effect. See Xavier Gabaix & David Laibson, Shrouded Attributes, Consumer Myopia and Information Suppression in Competitive Markets, 121 Q.J. Econ. 505, 506–09 (2006); Edward L. Glaeser, Psychology and the Market, 94 Am. Econ. Rev. 408, 409–11 (2004) ("Markets do not eliminate (and often exacerbate) irrationality. . . ."). 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 more general critique of the role of the SEC in fostering public enthusiasm for stock investments, see Henry T.C. Hu, Faith and Magic: Investor Beliefs and Government Neutrality, 78 Tex. L. Rev. 777, 837–50 (2000).

our discussion of behavioral economics back to the discussion of light-touch regulation in the previous Section. Recall the idea that it is very difficult to create a strong equity culture when one does not exist. Status quo biases operate powerfully against putting one's money at risk in other people's hands. What prompts the shift toward greater willingness to invest in stocks, 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 (in other words, 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]

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.

In other words, a more mature retail financial marketplace is one where debiasing in the face of increasingly sophisticated mar-

[82] For an interesting discussion of the early days of retail investment in the United States, see Lawrence E. Mitchell, The Speculation Economy: How Finance Triumphed Over Industry 92–106 (2007).

[83] See Moloney, supra note 34, at 395–402 (showing the tension in European regulation between this image of investor sovereignty and the competing image of the investor in need of help). For an update, still recognizing the "largely 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 online 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).

keting 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 restraint deserve more academic scrutiny. One is legacy: as the U.S. equity markets came into maturity in the 1950s and 1960s, SEC regulation was largely disclosure-focused, creating a regulatory habit that is hard to break.[84] Another reason 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, that the Commission wanted to take on the problem of too much cost for too little return in mutual funds, or persistent kinds of conflict of interest. It has other tools in its kit besides rulemaking. For instance, I have long been intrigued by the almost completely unused power given the SEC to hold public hearings, at which witnesses 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).[85] The SEC could call directors, officers, stockbrokers, analysts, and anyone it wishes to account for behavior by Wall Street that it finds troubling, no doubt with substantial media coverage. Surprisingly, it does not.

One possible reason is that a portion of the excessive investor expenditures probably does go to enhancing market efficiency. Paying for research may not be individually efficient, but if all investors chose to free-ride, then market efficiency would decline. Investors, in other words, may unwittingly be subsidizing market efficiency as a public good. Were we convinced of an unbroken connection between what investors pay for and high quality research, there might be some sense to this subsidization. But the

[84] Congress, too, was so inclined. A good example would be the 1954 amendments to the Securities Act of 1933, which revised § 5 to allow aggressive oral solicitations of potential investors in public offerings before the final prospectus was ready for distribution. 15 U.S.C. § 77e (2006).

[85] See Securities Exchange Act of 1934 §§ 21(b), 22, 15 U.S.C. §§ 78u(b), 78v (2006). Nor does the SEC engage in investor education that pointedly demonstrates to investors the subtle ways the industry sells securities. See James A. Fanto, We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education, 49 Case W. Res. L. Rev. 105, 156–79 (1998). Of course, whether investor education of the conventional sort would work in any event is questionable. See David de Meza et al., supra note 63, at 10–15.

agency cost problems here suggest that much of the money is drained off,[86] making this possibility far more problematic, especially when largely left in the dark.

All the remaining explanations are political, which makes this another place to observe the institutionally bounded nature 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 United States 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, since it allows the Commission to vary its stance as political conditions permit, leaving investors paying the industry more than they should.

II. "ANTIFRAUD-ONLY" MARKETS

With the recent trend toward greater institutionalization, some important regulatory questions are self-evident. Does the SEC (and/or other regulators who have responsibility in financial services) do a good enough job of protecting retail investors who invest through an institutional intermediary (that is, does mutual fund regulation need reform)?[87] 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

[86] See Stephen J. Choi & Jill E. Fisch, How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries, 113 Yale L.J. 269, 309–12 (2003) (discussing conflicts of interest).

[87] See generally Martin E. Lybecker, Enhanced Corporate Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration, 83 Wash. U. L.Q. 1045 (2005); Alan R. Palmiter, The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing, 1 Brook. J. Corp. Fin. & Com. L. 165 (2006).

first drawn?[88] All these questions 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 grounds for deregulation. Examples would be shelf registration and simplified disclosure for well-known issuers. These, too, have received due attention,[89] 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.[90] 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 private investment, public equity ("PIPE") financing, whereby private investors—often hedge funds—invest in a company that agrees to register a public offering to facilitate the exit of the private investors through sales to retail and other public investors.[91] As a regulatory matter, PIPE financing occurs only if the 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 arrangements are not abusive per se, and are a means by which smaller issuers

[88] See generally Troy A. Paredes, On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission, 2006 U. Ill. L. Rev. 975 (2006).

[89] See generally Barbara Ann Banoff, Regulatory Subsidies, Efficient Markets and Shelf Registration: An Analysis of Rule 415, 70 Va. L. Rev. 135 (1984); Merritt B. 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. 851 (1992).

[90] See Markus K. Brunnermeier & Stefan Nagel, Hedge Funds and the Technology Bubble, 59 J. Fin. 2013, 2014 (2004) (introducing an empirical study showing that "hedge funds were riding the technology bubble" between 1998 and 2000).

[91] See William K. Sjostrom, Jr., PIPEs, 2 Entrepreneurial Bus. L.J. 381, 383 (2007).

unable to access the public markets for equity financing directly can do so indirectly, they also create severe problems (taking the form of so-called "death spiral" financing, insider trading, etc.).[92] 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.

The discussion to this point might create the impression that we can equate retail investment with lack of sophistication and institutional investment with sophistication. If that is right, then it might make sense to encourage a stark distinction between public and private capital markets, letting the latter grow without substantial regulation based on the belief that, in contrast to the public markets, sophisticated participants can "fend for themselves." In this Part, I would like to engage in a thought experiment, imagining the emergence of deep, liquid trading markets for corporate securities in the United States that are *entirely* wholesale.[93] What should securities regulation look like in that kind of market? What I want to test is the supposition that these would truly be "antifraud-only" markets, with no legally mandated disclosure or corporate governance rules and with presumably low-intensity SEC enforcement. 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 certainly worth careful exploration, and no doubt greater regulation is coming. Here, however, I want to think more abstractly 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.

[92] See Compudyne Corp. v. Shane, 453 F. Supp. 2d 807, 821–28 (S.D.N.Y. 2006).

[93] Stephen Choi's often-cited article that suggests 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, 300–02 (2000).

To be clear, I am not addressing (at least directly) the bigger question of whether institutional investors need protection from sales practice abuses by the securities industry. Recent events strongly suggest that, at least as applied to complex financial products like collateralized debt obligations and auction-rate securities, there is both motive and opportunity for abuse. The very recent Madoff scandal underscores that there can be harmful misplaced trust by institutional investors in their portfolio managers and others who market investment services.[94] Rather, my focus is on the narrower issue of whether we can comfortably deregulate the issuer disclosure side of securities regulation for an institutional marketplace.

The prevailing assumption is that the answer is "yes." The decision by Congress to exempt nonpublic 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 do not.[95] Ever since, 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 controversially determined in the early 1980s 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.[96] The wealth measure ("accredited investor" status triggered by an annual income of $200,000), though perhaps substantial then, has now been eroded by inflation so that many solidly upper middle-class investors now readily qualify.

But a more vexing problem lurked. Investors strongly desired liquidity, and 1933 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 re-

[94] See SEC, DOJ Charge Wall St. Veteran Over Multi-Billion Dollar Ponzi Scheme, 40 Sec. Reg. & L. Rep. (BNA) 2049 (Dec. 15, 2008) (describing Madoff scandal). On the propensity of even "sophisticated" investors to be subject to abuse, see Langevoort, supra note 52, at 634–69.

[95] See SEC v. Ralston Purina Co., 346 U.S. 119, 124–27 (1953).

[96] See C. Edward Fletcher, III, Sophisticated Investors Under the Federal Securities Laws, 1988 Duke L.J. 1081, 1119–26 (1988); Mark A. Sargent, The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform, 68 Wash. U. L.Q. 225, 229–36, 273–78 (1990).

duced 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 qualified institutional buyer.[97] In so doing, the Commission set in motion the most interesting, and portentous, issue associated with institutionalization. Is it sound public policy to allow or encourage the development of purely private investment markets like this?[98] 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. As a result, 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 large-scale offerings under Rule 144A are starting to occur.[99]

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 public market. Second, only qualified institutional buyers—roughly, those managing more than $100,000,000—are currently eligible to participate as buyers. One effect of these limitations is to make 144A securities unusable as acquisition currency. But these limitations are 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 the threshold should not be as low as the one currently in place for accredited investors, which the SEC has considered increasing in any event,[100] but should

[97] See Cox et al., supra note 13, at 377–83. For a thorough discussion that takes Rule 144A up to its present status, see William K. Sjostrom, Jr., The Birth of Rule 144A Equity Offerings, 56 UCLA L. Rev. 409 (2008).

[98] For a preliminary discussion, see Langevoort, supra note 62, at 175.

[99] See Davidoff, supra note 6, at 339.

[100] See Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400, 405–07 (proposed Dec. 27, 2006) (to be codified at 17 C.F.R. pts. 230, 275).

comfortably include high net worth individuals[101] and (perhaps) high-ranking corporate insiders who buy 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 Regulation D private placement exemptive safe harbor.[102] But again, this is simply a thought experiment, so we can assume that the necessary pruning has taken place.

What I am advancing, 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, these markets 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 traded solely in the private market, offering a nice market test of the relative costs and benefits of the regulation triggered by being in the public market. Indeed, recent criticisms of U.S. public market regulation points to the growth of the 144A market as compelling evidence of gross regulatory inefficiency in public markets.[103]

There is a sound 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 are such that having a single standard setter (and enforcer) may 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

[101] The definition of "Qualified Investor" in Section 3(a)(54) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(54) (2006), which includes natural persons with assets under investment of more than $25 million, could be a useful model.

[102] See James D. Cox et al., supra note 13, at 300–07.

[103] See Comm. On Cap. Mkts. Reg., Interim Report of the Committee on Capital Markets Regulation 45–47 (2006), available at http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf; Comm. on Cap. Mkts. Reg., The Competitive Position of the U.S. Public Equity Market 17–20 (2007), available at http://www.capmktsreg.org/pdfs/The_Competitive_Position_of_the_US_Public_Equity_Market.pdf.

some other private body might be better than the SEC at setting these standards. I do not want to pursue this particular question, though, because it has been so thoroughly discussed in law review literature—indeed, it was probably the most important topic in securities regulation scholarship during the 1980s and 1990s.[104]

To address the need or use for 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 on this question. 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.[105] 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.

[104] See, e.g., John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717, 722 (1984); Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 672–73 (1984); Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment, 85 Va. L. Rev. 1335, 1339–42 (1999); Marcel Kahan, Securities Laws and the Social Costs of "Inaccurate" Stock Prices, 41 Duke L.J. 977, 979–82 (1992); Paul G. Mahoney, The Exchange as Regulator, 83 Va. L. Rev. 1453, 1454–56 (1997).

[105] See, e.g., Michael S. Haigh & John A. List, Do Professional Traders Exhibit Myopic Loss Aversion? An Experimental Analysis, 60 J. Fin. 523, 524 (2005) (offering evidence that professional traders show *more* myopic loss aversion than control group); Guillermo Baquero & Marno Verbeek, Do Sophisticated Investors Believe in the Law of Small Numbers? 26–29 (Mar. 15, 2006) (unpublished manuscript, available at http://ssrn.com/abstract=891309) (concluding from field study evidence that investors use an irrational heuristic to select hedge fund managers). Not surprisingly, however, there is also ample evidence of more rational behavior. See, e.g., Jonathan E. Alevy et al., Information Cascades: Evidence from a Field Experiment with Financial Market Professionals, 62 J. Fin. 151, 175 (2007) (concluding from experimental data that "professionals are more sophisticated in their use of public information" than students).

The standard economic objection to this is that such biases, even if they are natural and commonplace, could not possibly survive the pressures of competition. Weak decisionmakers will be weeded out; the strong will survive. This is a complicated subject that we cannot explore in detail. Instead, I will make just a couple of important points. First, the intensity of 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 noncompetitive settings when seeking investor funds. Those who do compete for retail investor money 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. Furthermore, performance feedback in investing can itself be ambiguous. Take, for instance, an overconfident portfolio manager who makes unjustifiable bets. Over large numbers of iterations, many of these managers 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 such that many bets are paying off, it makes it even harder. The foolish, but lucky, can survive, even flourish, and others may even follow them.[106]

But that is just one school of thought. The alternative points out that much of what we have just described are simply manifestations of agency costs, not behavioral biases. In other words, assuming 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 is weak. In a setting where compensation is a percentage of assets under management (mutual funds being a prime example), we are likely to observe herding among portfolio managers—buying, holding, and selling particular securities because that is what other

[106] 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 1990s. See Robin Greenwood & Stefan Nagel, Inexperienced Investors and Bubbles 2–4 (Nat'l Bureau of Econ. Research, Working Paper No. 14111, 2008), available at http://www.nber.org/papers/w14111.

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.[107] Likewise, if 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—that is, to gamble with house money.[108]

Much work in financial economics today seeks to disentangle behavioral from agency cost explanations for marketplace defects, but the effort is a challenge. Crucially related to this ambiguity 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.[109] During the tech stock bubble of the late 1990s, 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 portfolio managers that stayed away from an aggressive position in such stocks paid a severe market price for their prudence before the bubble finally burst.[110]

Whether or not we assume judgmental bias on the part of portfolio managers, then, there is likely to be some level of suboptimal

[107] See Nishant Dass et al., Mutual Funds and Bubbles: The Surprising Role of Contractual Incentives, 21 Rev. Fin. Stud. 51, 52 (2008). But cf. Mark Grinblatt et al., Momentum Investment Strategies, Portfolio Performance, and Herding: A Study of Mutual Fund Behavior, 85 Am. Econ. Rev. 1088, 1104 (1995) (finding "statistically significant, but not particularly large" levels of herding). There are multiple reasons for herding beyond reputational incentives; however, those incentives are well recognized as an important causal explanation. See David S. Scharfstein & Jeremy C. Stein, Herd Behavior and Investment, 80 Am. Econ. Rev. 465, 466 (1990).

[108] See Keith C. Brown et al., Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry, 51 J. Fin. 85, 88 (1996).

[109] See, e.g., Jorge A. Chan-Lau & Li Lian Ong, U.S. Mutual Fund Retail Investors in International Equity Markets: Is the Tail Wagging the Dog? 15 (Int'l Monetary Fund, Working Paper No. 05/162, 2005), available at http://www.imf.org/external/pubs/ft/wp/2005/wp05162.pdf.

[110] See Brunnermeier & Nagel, supra note 90, at 2032 (describing the demise of the Tiger hedge fund, which sold short in anticipation that there was a market bubble).

investment behavior even in entirely institutional markets. Both behavioral and agency cost explanations predict 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 a strong prima facie case for regulation in these kinds of settings, probably greater than now exists.

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 intrusive issuer disclosure regulation by the SEC. As financial economics has long highlighted, the presence of smart money can neutralize the harms of noise traders through arbitrage.[111] The weight of research on institutional traders indicates that they are often savvy, and if we assume the absence of retail traders from this market—generally agreed to be the major source of noise[112]—efficiency conditions are that much better. To the extent that 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 ability to absorb losses 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 from issuer concealment, but rarely drastically. As such, they can more easily be told simply to learn from the experience, not repeat the mistake, and seek damages if fraud can be proven.

[111] An interesting question would be the extent to which the private market encourages short-selling beyond what is permitted in the public. Short selling constraints are an important reason for less than full market efficiency in the public markets. If so, 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.

[112] A classic study is Charles M.C. Lee, Earnings News and Small Traders: An Introductory Analysis, 15 J. Acct. & Econ. 265, 266 (1992) (observing that small trades "display a puzzling propensity toward buys during earnings announcement periods irrespective of the type of news release"). For more recent extensions, see, for example, Ulrike Malmendier & Devin Shanthikumar, Are Small Investors Naïve About Incentives?, 85 J. Fin. Econ. 457, 458 (2007); Zur Shapira & Itzhak Venezia, Patterns of Behavior of Professionally Managed and Independent Investors, 25 J. Banking & Fin. 1573, 1584–85 (2001); Alok Kumar, Hard to Value Stocks, Behavioral Biases and Informed Trading (Mar. 13, 2008) (unpublished manuscript, available at http://ssrn.com/abstract=903820).

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,[113] 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 price the chosen forms of disclosure and governance *reasonably* well makes it likely that investors, on average, would be better off than under detailed mandatory rules from which 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 sufficiently attractive to issuers that large numbers migrate to it.[114] Would the antifraud-only approach be politically sta-

[113] A study of capital-raising transactions by European issuers pursuant to Rule 144A compared to conventional registered offerings found that they are less costly, though not dramatically less as some would expect. Institutional buyers in 144A deals insist on a high level of protection, including some mandatory disclosure and so-called 10b-5 representations. See Howell E. Jackson & Eric J. Pan, Regulatory Competition in International Securities Markets: Evidence from Europe—Part II, 3 Va. L. & Bus. Rev. 207, 251–54 (2008).

[114] I am assuming here a continuation of the non-fungibility rule, so that issuers would have to choose one or the other market 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 Cox et al., supra note 13, 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 may well decide that they like public markets better, precisely because of the greater opportunity for entrenchment and manipulation of noise traders, and therefore 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

ble? 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). The point is not as simple as regulatory aggrandizement, that is, that the SEC has an instinct for intervention simply to preserve or 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—on nongovernmental 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, cities, and perhaps even a handful of states.

This point is well-illustrated by the Enron and WorldCom scandals. When Enron and WorldCom fell, the harm was fairly diffused among investors. The markets for both companies' stock were heavily institutional, and so as far as conventional retail investors were concerned, putting aside some aberrant exceptions, losses were confined to portions of portfolios. The more severe pain was felt by 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 sizable 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 by itself caused at least $7.8 billion in harm to companies like Sprint, Verizon, and AT&T.[115]

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, particularly in its effort to enhance transparency (risk disclosure, internal controls, etc.), accountability (executive

encourage issuers and insiders to choose public rather than private market access in corporate financing decisions.

[115] See J. Gregory Sidak, The Failure of Good Intentions: The WorldCom Fraud and the Collapse of American Telecommunications After Deregulation, 20 Yale J. on Reg. 207, 235 (2003).

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.[116] That these have potential benefits for investors as well is certainly possible; I am not suggesting, as others might, that Sarbanes-Oxley and contemporary securities regulation are investor-insensitive. These changes were partly, if not entirely expertly, designed to restore investor confidence.[117] 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.[118]

If that is right, then we should not expect the SEC or the public to be comfortable with a large-scale shift of issuers to a private market in which these public claims simply disappear, even if they decide that investors themselves would be better off. To be sure, the private equity buyouts of the last decade or so have had that same effect. But the number of private large companies in the United States is 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.

[116] See Donald C. Langevoort, The Social Construction of Sarbanes-Oxley, 105 Mich. L. Rev. 1817, 1828–33 (2007). For a somewhat similar argument, see generally Cary Coglianese, Legitimacy and Corporate Governance, 32 Del. J. Corp. L. 159, 162–66 (2007).

[117] Put another way, in the aftermath of Enron and WorldCom there was substantial doubt whether there was enough regulation to deal with the incentives to cheat; at the same time, there was also substantial doubt about whether any, and if so which, strategies could make deterrence stronger without costs and consequences worse than the cure. There were plausible ideas about how to respond, though very little hard data to bolster them. Responding to immense political pressure, Sarbanes-Oxley took a scattergun approach. In all likelihood, some ideas will prove to have been good, others not, largely depending on the quality of implementation by the SEC and Public Company Accounting Oversight Board ("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.

[118] See Leonce Bargeron et al., Sarbanes-Oxley and Corporate Risk-Taking 1 (Mar. 6, 2008) (unpublished manuscript, available at http://ssrn.com/abstract=1104063).

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"; thus, issuers included in the secondary trading system are not exchange-traded and therefore not subject to the Securities Exchange Act's ongoing 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.[119] But in 1964, Congress added a distinct basis for registration under Section 12(g) of the 1934 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 of 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.[120]

There are only two means of avoiding public company status even in a nonpublic 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 1934 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 nonexchange marketplace the ability to avoid public company responsibilities for issuers traded solely inside the system simply by styling the shareholding arrangements as mandatory collective 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 pro-

[119] See Cox et al., supra note 13, at 1021.
[120] Id. at 548–53.

vide objective standards for close judgment calls (for example, whether there are one or two record holders when a security is 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)" (that is, to avoid registration when there apparently should be registration). Arguably, the Commission could invoke this when public company status is defeated simply by architectural design.

Even if not invoking Subsection (b)(3), 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 means that it could impose additional disclosure requirements as a condition for any such relief. 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 1934 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 (the financial media, for example) 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, preferred stock, and 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 successful, large-scale private market alternative, it will either decide otherwise or embark on a process of facilitating that growth 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.

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 1933 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.[121] Foreign issuers can avoid 1933 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.[122] Recent evidence suggests that foreign issuers have become somewhat more hesitant to register with the SEC;[123] what that means for U.S. investors is less information and direct access to non-cross-listed foreign securities. But technology has substantially reduced the burden of locating and trading in such stocks, and brokerage firms like Charles Schwab and E*TRADE now aggressively advertise that their customers can cheaply direct trades to markets around the world.[124]

U.S. retail investor participation in global securities investment is institutionalized to a greater extent than domestic investment. Presumably, this reflects less familiarity with particular foreign is-

[121] Id. at 222–23.
[122] Id. at 551–53.
[123] Each of the recent studies questioning U.S. competitiveness in the global securities markets has made much of the drop in cross-listings. See supra note 103.
[124] See Aaron Lucchetti, How to Buy Foreign Shares, Wall St. J., Aug. 12–13, 2006, at B1.

suers and markets; there has long been a well-known "home country bias" on the part of investors.[125] 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 interest in addressing through some form of regulatory liberalization. The first, and easiest, is whether to allow U.S. brokers to have foreign trading screens[126]—that is, 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 United States for 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 online 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 for institutional and very wealthy U.S. investors, but drew the line far short of retail investors.[127] Here, we see hints of a much debated subject—mutual recognition.[128] 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 ponder further liberalization—including access to a greater number of individuals and households—so long as they find that the regulatory system in the home country is sufficiently comparable with what is found in the

[125] See, e.g., Gur Huberman, Familiarity Breeds Investment, 14 Rev. Fin. Stud. 659, 659 (2001).

[126] Howell E. Jackson et al., Foreign Trading Screens in the United States, 1 Cap. Mkts. L.J. 54, 54–55 (2006).

[127] This would amend SEC rule 15a-6, which deals with registration by foreign broker-dealers. See Exchange Act Release No. 58,047, 73 Fed. Reg. 39182 (2008), *reprinted in* [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,235, at 86,787 (July 9, 2008).

[128] For a set of ideas put forward by SEC officials, see Ethiopis Tafara & Robert J. Peterson, A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework, 48 Harv. Int'l L.J. 31, 55–57 (2007).

United States.[129] If so, then U.S. securities law becomes antifraud-only as applied to the foreign actors. Recently, the SEC entered into agreements with Australia and Canada to explore a program of mutual recognition.[130]

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 United States. 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 sufficiently comparable securities regulation in their home country and adequate 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 in this context. But before turning to this issue directly, another connection deserves note. The United States is the only country in the world with a truly broad and active retail investor base for direct equity investment.[132] In most 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 European Union wants to en-

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[129] Id. at 58–61; see also Erik R. Sirri, Director, Div. Mkt. Reg., Sec. & Exch. Comm'n, A Global View: Examining Cross-Border Financial Services, Speech at Whistler, B.C., Canada (Aug. 18, 2007) (transcript available at http://www.sec.gov/news/speech/2007/spch081807ers.htm).

[130] See Press Release, Sec. & Exch. Comm'n, SEC, Australian Authorities Sign Mutual Recognition Agreement (Aug. 25, 2008) (available at http://www.sec.gov/news/press/2008/2008-182.htm); Press Release, Sec. & Exch. Comm'n, Schedule Announced for Completion of U.S.-Canadian Mutual Recognition Process Agreement (May 29, 2008) (available at http://www.sec.gov/news/press/2008/2008-98.htm).

[131] See John W. White, Director, Div. Corp. Fin., Sec. & Exch. Comm'n, Corporation Finance in 2008–International Initiatives, Remarks Before PLI's Seventh Annual Institute on Securities Regulation in Europe (Jan. 14, 2008) (transcript available at http://www.sec.gov/news/speech/2008/spch011408jww.htm).

[132] Australia and Canada have achieved substantial development of the retail base.

courage more direct retail participation, and Great Britain is probably the country in Europe where this is most feasible. But even there, change is slow. In part, 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, and many public markets in Western Europe were deeper and stronger than in the United States. 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.[133] 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 with an institutional marketplace specifically 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.[134]

Put bluntly, mutual recognition is hard to justify as applied to the retail securities industry. For the reasons developed in Section I.A., European securities regulation lacks most of what the United States has built over some seventy years in terms of broker-dealer regulation. In the United States, much of the work is done by the major self-regulatory organization, FINRA, whose principles and rules are replete with retail-investor oriented protections. 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

[133] See Mark J. Roe, Legal Origins, Politics, and Modern Stock Markets, 120 Harv. L. Rev. 460, 488–89 (2006). In the United Kingdom, tax policy and other factors also contributed to increasing institutionalization after World War II. See Armour & Skeel, supra note 36, at 1768–70.

[134] For a thoughtful exploration of how mutual recognition ideas might be applied, see Howell E. Jackson, Toward a New Regulatory Paradigm for the Trans-Atlantic Financial Market and Beyond: Legal and Economic Perspectives, 10 Eur. Bus. Org. L. Rev. (forthcoming 2009).

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 United States 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.

In contrast, European regulation seems far 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 ongoing issuer disclosure and the potential for market abuse.[135] In terms of formal regulatory demands, there are numerous ways in which its mandates for issuers actually exceed what we have in the United States. But it is also far less enforcement-oriented,[136] 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. As the European capital market grows and becomes more diverse—including somewhat greater retailization—these features are likely to weaken. As a corollary, we might expect greater enforcement intensity in the future.[137] Indeed, there are already signs of this. That being said, any increase in enforcement intensity that comes close to matching what we observe in the United States, where a different, retail-driven demand exists, is implausible.

The question that the United States would face under a mutual recognition regime is whether that kind of institutional investor-oriented approach could be properly 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 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

[135] This was the subject of the E.U.'s Market Abuse Directive. See Guido A. Ferrarini, The European Market Abuse Directive, 41 Common Mkt. L. Rev. 711, 732–34, 741 (2004).

[136] See Coffee, supra 19, 308–11.

[137] See Armour, supra note 43, at 21–22.

is not a persuasive enough argument to lead to the conclusion that a mixed institutional-retail marketplace will consistently govern price issuers' governance and disclosure well enough such that no further regulatory intervention is warranted; at the very least, the United States 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.[138] Thus, market efficiency alone should not be the basis for deference to foreign regulation.

This reasoning would suggest 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 fend for themselves effectively with the legal and extra-legal tools at their disposal, and are diversified enough to absorb the remaining risk from lesser transparency. And there are not enough retail investors to warrant a departure from this expectation. Given that, it makes sense to lighten up on regulatory requirements (for example, to put 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 essentially 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.[139]

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

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[138] See John C. Coates IV, The Goals and Promise of the Sarbanes-Oxley Act, 21 J. Econ. Persp. 91, 91–93 (2007).

[139] See Kate Litvak, Sarbanes-Oxley and the Cross-Listing Premium, 105 Mich. L. Rev. 1857, 1897–98 (2007); Joseph D. Piotroski & Suraj Srinivasan, Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings 1–8 (Jan. 2008) (unpublished manuscript, available at http://ssrn.com/abstract=956987).

U.S. securities law can be notoriously expansive,[140] especially in public enforcement. But, there is reason to doubt that the expansiveness (or willingness to enforce) is quite so strong when applied extraterritorially. 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. 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 probably acknowledge that mutual recognition increases the risk to less well-diversified retail investors, which may be one reason the proposal has started to attract political opposition.[141] But the risk is diminished because of home bias: investors are probably far less likely to load up on a foreign company stock than a domestic one (the exception is where the foreign issuer has a large number of U.S. employees or other domestic presence, but this situation could be dealt with separately). Moreover, mutual recognition is just the continuation of steps that have been underway in U.S. securities law for some time now.[142] 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 force reconciliation to U.S. GAAP—among other initiatives—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 (shareholder voting, fiduciary duties, etc.), 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

[140] See Donald C. Langevoort, *Schoenbaum* Revisited: Limiting the Scope of Antifraud Protection in an Internationalized Securities Marketplace, 55 Law & Contemp. Probs. 241, 245–49, 252–53 (1992).

[141] See Rachel McTague, Reed to SEC: Slow Mutual Recognition; GAO Asked to Report on SEC Enforcement, 40 Sec. Reg. & L. Rep. (BNA) 530 (Apr. 7, 2008).

[142] See James D. Cox, Regulatory Duopoly in U.S. Securities Markets, 99 Colum. L. Rev. 1200, 1223–28 (1999) (describing SEC deregulation of nonexchange traded issuers).

a candid acknowledgement that there are two very distinct tiers of investor protection in the United States: a more rigorous standard for domestic companies and a less rigorous one for foreign companies.[143]

How do we justify this double standard, which is on the verge of being extended? No justification is needed, of course, for those who believe that the purported rigor of U.S. disclosure rules produces more costs than benefits even for retail investors—that is, that U.S. regulation is excessive in the first place.[144] Much of the applause for mutual recognition is probably 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 who are more reluctant to come to the United States because of regulatory burdens is made up of "lemons" whose managers or controlling shareholders covet the private benefits of that control.[145] The tradeoffs are not so obvious so as to count as particularly compelling.

[143] See Frederick Tung, Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation, 39 Ga. L. Rev. 525, 570–71 (2005).

[144] 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 reference to that regime. The motivation behind these proposals was skepticism about the overreach of U.S. securities regulation. See, e.g., Stephen J. Choi & Andrew T. Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 S. Cal. L. Rev. 903, 922 (1998); Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2425 n.216 (1998). These critics are therefore insistent that the SEC should not condition entry into the United States on the home country's regulatory regime being satisfactory to it.

[145] On signaling intentions regarding private benefits of control, see Michal Barzuza, Lemon Signaling in Cross-Listing 1–2 (Oct. 1, 2007) (unpublished manuscript, available at http://ssrn.com/abstract=1022282).

Another benefit is entirely political: the benefits that come 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) as more global capital markets transactions come to—rather than avoid—U.S. jurisdiction.[146] There is powerful pressure here, and little doubt that a strong securities industry presence in the United States 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 that 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.

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 directed not simply at investor protection but at the publicization of the governance of private sources of economic power. These reforms address 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 want U.S. securities law to apply as strictly (especially through Sarbanes-Oxley-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 United States,[147] but it was hardly viewed with the same alarm here

[146] 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 US' Global Financial Services Leadership (2007), available at http://www.nyc.gov/html/om/pdf/ny_report_final.pdf. This report was prepared under the direction of New York Senator Charles Schumer and New York City Mayor Michael Bloomberg.

[147] See Guido Ferrarini & Paolo Giudici, Financial Scandals and the Role of Private Enforcement: The *Parmalat* Case, *in* After Enron: Improving Corporate Law and Modernising Securities Regulation 158, 159–60 (John Armour & Joseph A McCahery eds., 2006).

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.

To be sure, 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 should not make too much of this. In their 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 made presumably with the expectation that the SEC (and the Public Company Accounting Oversight Board) 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 question becomes one simply of investor protection, and we are back to the tradeoffs described earlier. But perhaps we come to it with a bit less confidence in the case for these rules as essential investor protection in an increasingly institutionalized setting. If so, then mutual recognition is on balance a desirable strategy, 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 by the United States'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 tradeoffs (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 United States 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.[148] That is somewhat disorienting in our understanding of the 1934 Act, which makes listing on a national securities exchange the principal trigger for regulation in Section 12(b).[149] Section 12(g) is meant as a backup, 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 1934 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.[150] As institutionalization continues, there is good reason to suspect that global securities trading will be increasingly fragmented as many different sites in different countries compete with each other for order flow in the same security. Whether exchange listings are even sustainable as the primary test for whose regulation governs is unclear in a fragmented world: 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.[151]

[148] 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 B. Fox, The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities, 97 Mich. L. Rev. 696, 702 (1998). He plays down the investor protection need on grounds of market efficiency and portfolio diversification. Id. at 710–12, 743.

[149] A 12(b) model leads very clearly to strong international competition and something resembling issuer choice. See Chris Brummer, Stock Exchanges and the New Markets for Securities Laws, 75 U. Chi. L. Rev. 1435, 1435–39 (2008).

[150] There are also other marketplace forces that tie U.S. based issuers to home. See Tung, supra note 143, at 561–66.

[151] See Donald C. Langevoort, Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience, *in* Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond 485, 496–97 (Guido Ferrarini & Eddy Wymeersch eds., 2006).

CONCLUSION

There are three big-picture lessons about the SEC to take from the various topics covered in this Article. First, to repeat what now 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 could handle. More attention to behavioral economics could help explain subtle sales practices that have led to unsuitable or unbalanced portfolios and money being spent on unhelpful investment advice. Such scrutiny, in turn, 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, and if so, how long they will be in effect. 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 tradeoffs being made in an effort to support the United States as a desirable location for global capital activity, but that there is no well-theorized or candid commitment to that goal. Perhaps this is explained by mere politics, where both theory and candor are chronically in short supply. I suspect, however, that certain of these tensions and inconsistencies are, after seventy-five years, so far internalized that many of those inside the Commission simply do not recognize them. It is a form of institutional cognitive dissonance.[152] But repression comes at the price of both transparency and coherence.

The second main point to take away is that the political, social, and economic conditions that challenge securities regulation are contingent over time. As we have seen, no economy can build a strong retail investment culture without some degree of salesmanship to overcome the status quo biases that make people hesitate to

[152] 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. See Langevoort, The SEC as a Lawmaker, supra note 8, at 1624–25.

take on unfamiliar, complex forms of risk, even when it might be advantageous 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 United States 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 both this and the foreseeable consequence of that success: the securities industry is massively large and diffused culturally and geographically—with an impact amplified by a loud and persistent financial media—in ways that make strategies other than strong enforcement less likely to work. The troublesome question thus emerges whether the enforcement is strong enough, or whether the political power that comes with such success so frightens the SEC that—consciously or not—it leaves too much opportunism unaddressed.

From this we may also gain some insight into what we mean by the elusive phrase "investor confidence" that is so often invoked to justify regulation.[153] 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.[154] 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 with 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, the hard work of securities regulation may be less important than when investment cultures are more emergent. At the same time, however, the cultural shift to habituated investing invites opportunism in a scope and scale unimaginable during the

[153] See, e.g., Guiso et al., supra note 33; Lynn A. Stout, The Investor Confidence Game, 68 Brook. L. Rev. 407, 416 (2002) (discussing investors' adaptive expectations and consequent trust in market institutions).

[154] See Malcolm Baker & Jeffrey Wurgler, Investor Sentiment in the Stock Market, 21 J. Econ. Persp. 129, 144–50 (2007).

transition period, so that the focus of regulation should shift more deliberately to prevention and remediation of the excesses.

The third and final message links the point just made to the process of globalization. Recent critiques of the SEC and U.S. securities regulation rightly note the importance of comparisons, and show that other countries have had reasonable success in building capital markets without mimicking the United States. 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 it entails), the attraction of new and more diverse capital markets business, and the predictable stresses and scandals will test those regulatory strategies, and ultimately will alter them.

So maybe the SEC at age seventy-five should not seek a makeover to look as attractive as some of the younger agencies around the world, but rather should 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. But if institutionalization truly is the future, both in the United States and around the world, then the layers of retail investor-driven regulation that have accumulated over the last seventy-five years will surely weigh more heavily going forward.