

## WHITHER THE SEC NOW?

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ON Friday, September 26, 2008, the *Virginia Law Review* convened this symposium in recognition of the upcoming seventy-fifth anniversary of the Securities and Exchange Commission in 2009. That Friday immediately followed perhaps the most dramatic weeks in the Commission's history: the *Review* could not have chosen a more appropriate moment to host a symposium devoted to reconsidering the role of the SEC.

Only three weeks before the symposium, the Director of the Federal Housing Finance Authority seized Fannie Mae<sup>1</sup> and Freddie Mac,<sup>2</sup> putting the federal government in control of institutions whose aggregate debt and guarantees equaled the outstanding publicly held debt of the United States government itself.<sup>3</sup>

Then, a week later, early on the morning of Monday, September 15, Lehman Brothers Holdings ("Lehman Brothers") announced it would file for bankruptcy.<sup>4</sup> Later that same day, Merrill Lynch & Co. ("Merrill Lynch") hurriedly announced its distress sale to Bank of America Corporation.<sup>5</sup>

On Tuesday, September 16, the Reserve Primary Fund, a money-market fund that had ended the previous week with over

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\* The author served as General Counsel of the Securities and Exchange Commission from January 2006 to January 2009. The views expressed herein are his alone and do not necessarily reflect those of the Commission or his former colleagues.

This Comment does not reflect developments after December 31, 2008.

<sup>1</sup> The Federal National Mortgage Association.

<sup>2</sup> The Federal Home Loan Mortgage Corporation.

<sup>3</sup> Press Release, Fed. Hous. Fin. Auth., Statement of FHFA Director James B. Lockhart (Sept. 7, 2008), available at <http://www.ofheo.gov/newsroom.aspx> (follow "July-September" hyperlink under "2008"; then follow "Statement of FHFA Director James B. Lockhart" hyperlink).

<sup>4</sup> Press Release, Lehman Bros. Holdings Inc., Lehman Brothers Holdings Inc. Announces It Intends to File Chapter 11 Bankruptcy Petition (Sept. 15, 2008), available at [http://www.lehman.com/press/pdf\\_2008/091508\\_lbhi\\_chapter11\\_announce.pdf](http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf).

<sup>5</sup> Press Release, Merrill Lynch & Co., Inc., Bank of America Buys Merrill Lynch, Creating Unique Financial Services Firm (Sept. 15, 2008), available at [http://www.ml.com/index.asp?id=7695\\_7696\\_8149\\_88278\\_106886\\_108117](http://www.ml.com/index.asp?id=7695_7696_8149_88278_106886_108117) (follow "Newsroom" hyperlink; then follow "More Press Releases" hyperlink; then follow "2008" hyperlink).

\$60 billion in assets, was hit with an extraordinary level of redemptions, despite holding only about 1.2% of its assets in commercial paper issued by the newly bankrupt Lehman Brothers. As a result, the fund “broke the buck,”<sup>6</sup> something that had happened only once before in the history of money-market funds, and then only on a much smaller scale.<sup>7</sup> In short order, sleep-deprived policy makers began to hear reports that a run on the over \$3 trillion of accounts held in money-market funds<sup>8</sup> may have been developing, with potentially disastrous consequences.

As the alarming news of the run on the Reserve Primary Fund reverberated around the country, other money-market funds began unloading commercial paper, and the approximately \$800 billion market<sup>9</sup> for such short-term borrowing began to dry up. This threatened the liquidity of some of the most creditworthy of companies and applied added pressure on those banks that had afforded such companies lines of credit as backstops to their commercial paper programs.<sup>10</sup>

But Tuesday was not yet over: that evening, the Federal Reserve Board announced the government would loan American International Group (“AIG”) up to \$85 billion to prevent “a disorderly failure” of AIG.<sup>11</sup> In exchange, the government said it would receive a warrant for almost 80% of AIG’s equity and de facto control of yet another major financial institution.<sup>12</sup>

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<sup>6</sup> That is, its shares had a net asset value of less than one dollar.

<sup>7</sup> Press Release, The Reserve, A Statement Regarding the Primary Fund (Sept. 16, 2008), available at [http://www.reservefund.com/pdfs/Press%20Release%202008\\_0916.pdf](http://www.reservefund.com/pdfs/Press%20Release%202008_0916.pdf). Ironically, the affiliated Reserve Fund had been the first money-market fund to be established in the United States in 1970. Diana B. Henriques, Money Market Fund Warns its Customers Face Losses, N.Y. Times, Sept. 17, 2008, at C1.

<sup>8</sup> At the end of 2007, the net assets of money-market funds were \$3.1 trillion. See Inv. Co. Inst., 2008 Investment Company Fact Book 144 (48th ed. 2008), available at [http://www.icifactbook.org/pdf/2008\\_factbook.pdf](http://www.icifactbook.org/pdf/2008_factbook.pdf).

<sup>9</sup> See Fed. Reserve Bd., Commercial Paper Outstanding (2009), <http://www.federalreserve.gov/releases/cp/outstandings.htm>.

<sup>10</sup> The Federal Reserve later responded by creating a Commercial Paper Funding Facility. Press Release, Fed. Reserve Bd. (Oct. 7, 2008), available at <http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm>.

<sup>11</sup> Press Release, Fed. Reserve Bd. (Sept. 16, 2008), available at <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>.

<sup>12</sup> *Id.*

On Thursday, September 18, Senator John McCain, while campaigning for President in Green Bay, Wisconsin, called for the Chairman of the SEC to be fired.<sup>13</sup> The stock prices of the two largest remaining investment banks, which had plunged all week, continued to fall, and Morgan Stanley stock closed down sharply at 39.5% below its closing price at the end of the previous week,<sup>14</sup> amid widely voiced concerns that it—and then perhaps even Goldman Sachs Group—could follow the path earlier trodden by The Bear Stearns Companies and Lehman Brothers.<sup>15</sup>

In light of these developments, after meeting with President George W. Bush at the White House on Thursday afternoon, Secretary Paulson, Chairman Bernanke, and Chairman Cox met that evening with the Congressional leadership to urge an immediate emergency legislative response to the crisis.<sup>16</sup>

On Friday, the SEC announced an unprecedented ban on short sales of shares of an extensive list of financial institutions, among other emergency measures.<sup>17</sup>

Finally, on Sunday night, the Federal Reserve Board announced that Morgan Stanley and Goldman Sachs Group would convert to regulated bank holding companies,<sup>18</sup> effectively ending as a practical matter the division between investment banking and commercial banking that had been created by the Glass-Steagall Act of 1933.<sup>19</sup> By this conversion, Morgan Stanley and Goldman Sachs

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<sup>13</sup> See Robert Barnes & Michael D. Shear, *Obama, McCain Trade Shots Over Responses to Financial Meltdown*, Wash. Post, Sept. 19, 2008, at A3.

<sup>14</sup> Compare Market Gauges, N.Y. Times, Sept. 13, 2008, at C7 (showing that Morgan Stanley closed at \$37.23 per share on Friday, Sept. 12, 2008), with Market Gauges, N.Y. Times, Sept. 19, 2008, at C12 (showing that Morgan Stanley closed at \$22.55 per share on Thursday, Sept. 18, 2008).

<sup>15</sup> See, e.g., Vikas Bajaj et al., *Markets Soar, But New Rules Upset Traders*, N.Y. Times, Sept. 20, 2008, at A14.

<sup>16</sup> See, e.g., Patrice Hill, *Treasury, Congress Craft Loan Plan*, Wash. Times, Sept. 19, 2008, at A1.

<sup>17</sup> Press Release, Sec. & Exch. Comm'n, *SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets* (Sept. 19, 2008), available at <http://www.sec.gov/news/press/2008/2008-211.htm>.

<sup>18</sup> Press Release, Fed. Reserve Bd. (Sept. 21, 2008), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20080921a.htm>; see also Andrew Ross Sorkin & Vikas Bajaj, *Democrats Set Conditions on Bailout as 2 Firms End Investment Banking Era*, N.Y. Times, Sept. 22, 2008, at A1.

<sup>19</sup> Glass-Steagall Act of 1933, ch. 89, § 20, 48 Stat. 162, 188 (1933), repealed by Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (1999).

gained access to the liquidity support provided by the Federal Reserve Board's Primary Dealer Credit Facility.<sup>20</sup>

Not since the Great Depression had United States financial regulators faced such challenges. By the time of the *Review* symposium just five days later, the role of the SEC—indeed, whether the SEC should exist in its current form at all—had become a topic that, perhaps for the first time in the SEC's seventy-five-year history, was not merely of academic interest, but of urgent practical importance.

#### INTRODUCTION

Professor Langevoort's thoughtful article<sup>21</sup> was prepared and distributed to symposium speakers prior to the startling events of September 2008, and he, no more than anyone else, could not have anticipated those events.<sup>22</sup> Professor Langevoort's article focuses on the consequences of deretailization, a trend I spotlighted earlier in a speech delivered in October 2007.<sup>23</sup> Professor Langevoort concludes that deretailization raises "scores of academically interesting questions."<sup>24</sup> I certainly agree.

But deretailization is just one of four closely interrelated and mutually-reinforcing long-term trends that have now overtaken the SEC, causing even the SEC's future to be called into question. And like the SEC, too many commentators with an interest in the

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<sup>20</sup> Fed. Reserve Bd., *supra* note 18.

<sup>21</sup> Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 Va. L. Rev. 1025 (2009).

<sup>22</sup> Or those that followed, such as the revelation that Bernard L. Madoff Investment Securities LLC had operated a Ponzi scheme of unprecedented proportions. See Press Release, Sec. & Exch. Comm'n, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme (Dec. 11, 2008), available at <http://www.sec.gov/news/press/2008/2008-293.htm>.

<sup>23</sup> Brian G. Cartwright, General Counsel, Sec. & Exch. Comm'n, *The Future of Securities Regulation*, Address at the University of Pennsylvania Law School Institute for Law and Economics (Oct. 24, 2007) (transcript available at <http://www.sec.gov/news/speech/2007/spch102407bgc.htm>). Professor Langevoort eschews my coinage of "deretailization" in favor of "institutionalization," which is, of course, his prerogative. Terminology can subtly influence thinking, however, and so I continue to prefer "deretailization," since it places the emphasis both on the retail investor and on the retail investor's diminishing role in some markets and absence in others. As the primary focus of the SEC should, in my view, remain protection of the retail investor, I prefer to retain this linguistic emphasis.

<sup>24</sup> Langevoort, *supra* note 21, at 1026.

agency have been unduly distracted by images in the rear-view mirror.<sup>25</sup> As a result, commentators have tended, in the words of Vice Chancellor Strine, to “fetishize the agency costs that flow from the separation of ownership and control,”<sup>26</sup> while failing to devote sufficient attention to the consequences of the challenging new reality that these four long-term trends have created.

In this Article, a response to Professor Langevoort, and within the modest space allotted to me by the editors of the *Review*, I will first very briefly recall the world out of which the SEC grew. I will next describe, necessarily in only broad terms, the four long-term trends to which the SEC must adapt, and then briefly suggest what all this should imply for the future of the agency. I will conclude by calling for an interdisciplinary program dedicated to deeper analysis of these trends with the aim of developing more sophisticated protections for intermediated retail investors.

#### I. THE BYGONE WORLD THE SEC WAS BUILT TO REGULATE

The SEC is the product of the world of the 1930s and the decades immediately following. In that world, unintermediated retail investors owned nearly all the public float of listed corporations. Investing was an almost purely domestic matter. The New York Stock Exchange was a nonprofit. Broker-dealers could not compete on price. For all but the most elite companies, banks were the source of debt financing. Early in the period, computers had not yet been invented; later in the period, computers were still only in their infancy. A long-distance call required the manual efforts of an operator. A securities analyst may find the rules of compound interest useful; otherwise, grade school arithmetic was all the mathematics he would need.

The SEC's DNA was formed in such a world, but that world began fading thirty to forty years ago as the four trends I focus on here began to emerge. And increasingly, it is impossible to avoid the conclusion that the SEC has insufficiently adapted to the

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<sup>25</sup> Cf. Marshall McLuhan & Quentin Fiore, *The Medium is the Massage* 63, 100 (1967) (discussing the need to move from an educational perspective that focuses on the rear-view mirror to one that is proactive and forward looking).

<sup>26</sup> Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 *J. Corp. L.* 1, 6 (2007).

changed circumstances in which it now finds itself. Pondering the SEC's future requires an understanding of these changed circumstances. So, I next identify and describe the four closely interrelated, mutually reinforcing, long-term trends to which the SEC now must adapt.

## II. THE BIG FOUR

### *A. Deretailization*

Professor Langevoort says it well: “the market for corporate securities traded on the New York Stock Exchange or the NASDAQ Global Market is no longer substantially retail in nature.”<sup>27</sup> In fact, the market is overwhelmingly dominated by institutional investors.<sup>28</sup> Nonetheless, the SEC still “thinks of itself as the investors’ advocate, by which it means retail investors . . . [T]hroughout 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.”<sup>29</sup> As a result, 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.<sup>30</sup>

That is indeed *the* question. In his article, Professor Langevoort offers a nuanced examination of some considerations relevant to answering it, but ultimately declines to hazard a firm conclusion. It seems Professor Langevoort would very much like to conclude that the SEC in fact is “competitively fit” or, at a minimum, could be made so with only relatively minor renovations. But Professor Langevoort evidently cannot quite reach that destination, and neither can I. The closing sentence of his article somberly notes: “if institutionalization truly is the future, both in the United States and around the world, then the layers of retail investor-driven regula-

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<sup>27</sup> Langevoort, *supra* note 21, at 1026. See also Cartwright, *supra* note 23.

<sup>28</sup> Langevoort, *supra* note 21, at 1026.

<sup>29</sup> *Id.* at 1025.

<sup>30</sup> *Id.* at 1027.

tion that have accumulated over the last seventy-five years will surely weigh more heavily going forward.”<sup>31</sup>

Deretailization calls into question not only the SEC’s competence to deal adequately with today’s primarily institutional markets, but also the SEC’s base of political support. The SEC articulates a tripartite mission: “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”<sup>32</sup> But, as Professor Langevoort emphasizes, attention to the rhetoric employed by SEC officials and by the SEC’s supporters in the press, on Capitol Hill, and elsewhere reveals that the emotional energy driving the SEC’s activities—and providing its political clout—derives first and foremost from its protection of retail investors.

The SEC is part of the government: it is inherently a political instrumentality. As such, it must be responsive to the political currents that energize the press and Capitol Hill.<sup>33</sup> The demands of politics in a democracy also require a consistent, easily understood message with substantial mass appeal. Protection of the retail investor from greed and malfeasance fits that bill. Lowering bid-ask spreads by a penny just doesn’t cut it to the same extent—nor does slicing ten basis points off the cost of raising equity capital for public corporations.

Moreover, emphasizing protection of retail investors enables the SEC to align itself with the perennially popular consumer protection movement that crystallized in its modern form after Ralph Nader’s 1965 publication of *Unsafe At Any Speed*.<sup>34</sup> Much of the enduring appeal of that movement stems from its presentation of itself as the advocate of the “little guy” at risk of being trampled by the unchecked greed of powerful, politically connected businesses. The SEC is able to make common cause with this movement by

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<sup>31</sup> Id. at 1083.

<sup>32</sup> Sec. & Exch. Comm’n, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation* (2009), available at <http://www.sec.gov/about/whatwedo.shtml>.

<sup>33</sup> The SEC is one of the “independent” agencies, and the President’s influence over the SEC is muted, at best, after his appointment of its commissioners.

<sup>34</sup> Ralph Nader, *Unsafe at Any Speed* (25th anniversary ed., Knightsbridge Publ’g Co. 1991).

implicitly equating the retail investor who buys a security with the retail customer who buys a consumer product.<sup>35</sup>

Simply stated, the protection of retail investors is politically rewarding. Protection of large and well-heeled institutional investors—like hedge funds—is less so. Deretailization thus threatens eventually to undermine the SEC's base of rhetorical and political support. But it is nonetheless the protection of the dwindling numbers of unintermediated retail investors that remains the SEC's primary focus and core competence.

Retail investors have not vanished, however. As I have emphasized before, they have simply shifted to investing primarily through financial intermediaries such as mutual funds.<sup>36</sup> So it would seem to be a patently obvious move for the SEC simply to follow the path of its primary constituency and shift more of its emphasis—both rhetorical and substantive—to the protection of retail investors when they engage with financial intermediaries. Of course, the SEC has long had a statutory mandate enabling it to do just that,<sup>37</sup> though this mission to date has commanded only a modest fraction of the “mind share” of not only the SEC but also of those who follow it in the press and academia.

How well does the SEC address this important task, one that should now be at the center of its mission? In his article, Professor Langevoort considers the effectiveness of the SEC in this role and, though his analysis is careful and moderate throughout, in the end he gives the SEC only passing marks, at best: “the SEC is the retail

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<sup>35</sup> The analogy, of course, is quite imperfect: unlike a retail customer, a retail investor owns—along with others—the very business whose conduct is challenged, which leads to complications. For example, scholars have identified the many imperfections of securities class actions, whose proponents often draw their rhetoric from the consumer protection well. But the investors whose interests as a group are to be vindicated by class actions also own the enterprises and, as such, indirectly bear the burden of funding class action settlements. There is extensive academic literature examining this topic. See, e.g., Donald C. Langevoort, *On Leaving Corporate Executives “Naked, Homeless and Without Wheels”*: Corporate Fraud, Equitable Remedies, and the Debate Over Entity Versus Individual Liability, 42 *Wake Forest L. Rev.* 627, 627–31 (2007).

<sup>36</sup> Cartwright, *supra* note 23.

<sup>37</sup> Through the Investment Company Act of 1940, ch. 686, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a–1 to 80a–64 (2006)) and the Investment Advisers Act of 1940, ch. 686, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b–1 to 80b–21 (2006)). These Acts are showing their age and in need of modernization. But that is a question for another day.



investor's champion only in a bounded way."<sup>38</sup> Further, Langevoort argues that the SEC has not adequately addressed "subtle sales practices that have led to unsuitable or unbalanced portfolios and money being spent on unhelpful investment advice."<sup>39</sup> He continues, "Nor is there any coherent SEC policy on the disclosure of conflicts of interest in the securities business."<sup>40</sup> Professor Langevoort concludes that the SEC's effectiveness suffers because it continues to operate "without generating either a general theory or deep empirical knowledge about opportunism in the securities business."<sup>41</sup> He views the SEC's performance as limited by its "legacy [from the] 1950s and 1960s [that has] creat[ed] a regulatory habit that is hard to break."<sup>42</sup>

Professor Langevoort gives us a nuanced presentation that is far from wholly critical of the SEC.<sup>43</sup> But his analysis is consistent with my view that, as the relative importance of the protection of unintermediated retail investors has declined, the SEC has yet to provide sufficiently sophisticated protections for intermediated retail investors. This is problematic and imprudent for an agency whose primary mission is the protection of retail investors and whose principal constituency consists of such investors.

If the SEC has yet to shift sufficient emphasis to the protection of intermediated retail investors, does it have other viable alternatives? What about the institutional securities markets in which retail investors now play an ever-decreasing role or markets that have developed over the last few decades without retail investors at all? How suited is the SEC to regulate institutional securities markets? Is that portion of the market instead where the SEC's future lies?

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<sup>38</sup> Langevoort, *supra* note 21, at 1081.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 1051.

<sup>41</sup> *Id.* at 1055.

<sup>42</sup> *Id.* at 1054.

<sup>43</sup> For the record, I should note that I do not find myself in entire accord with all of Professor Langevoort's analysis here, though I am in agreement with its thrust—which suffices for present purposes.

*B. The Shift to Securities-Centric Finance*

It would be tempting for the SEC to conclude that its future lies in institutional securities markets. Institutional securities markets have experienced explosive growth for several decades, and recent events surely have demonstrated that an adequate regulatory response is overdue. The problem for the SEC is that the regulation that is most needed is of a very different sort from the type of regulation the SEC offers.

To see why, we must turn our attention to a trend closely related to deretailization and of at least equal importance: the decades-long shift away from bank-centric debt financing and toward securities-centric debt financing.<sup>44</sup> This shift, unaccompanied as it was by an adequate regulatory response, is one of the principal root causes of the dramatic events of September 2008.

What does the shift toward securities-centric debt financing involve? In the traditional bank-centric model, individuals and businesses deposited money in a bank, which then loaned money to other individuals and businesses, thereby earning as income the spread between interest rates paid and interest rates received.<sup>45</sup> These loans were typically held to maturity in the bank's portfolio.

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<sup>44</sup> To emphasize the diminished role of banks, I might use the coinage "debankification," but given Professor Langevoort's reaction to my coinage of the term "deretailization," Langevoort, *supra* note 21, at 1026–27 n.6, I refrain from doing so here out of respect for his aesthetic sensibilities (though I make no promises regarding future use elsewhere).

Various aspects of the trend toward securities-centric debt financing have been given various designations over time. The shift from bank deposits to money-market funds and other higher-yielding alternatives, for example, was often referred to while it was under way as "disintermediation." I find this designation inadequate for present purposes, however, because present-day alternatives often involve new intermediary entities of their own. Similarly, corporate debtors' shift from reliance on bank loans to the issuance of bonds, debentures, and other debt securities has been referred to as "securitization." I find this designation also inadequate, because the same term confusingly is used to describe the altogether different phenomenon of the issuance of securities that pass through to investors the cash flows from an underlying pool of assets.

<sup>45</sup> For the sake of simplicity, I use the term "bank" throughout this Article not in its technical sense, but rather to refer more generally to any deposit-taking or similar financial institution. In addition, non-deposit-taking financial institutions also were involved in the traditional model. For example, individuals and businesses paid premiums to insurance companies, which then in turn invested those premiums in other businesses, often in the form of loans held to maturity (capital market participants today sometimes refer to financing of this type by insurance companies and others as

Banks thus served as indispensable nodal points between capital providers and users. Regulation of credit and the credit market as a whole could therefore readily be accomplished simply by the regulation of banks—hence, in the United States, the development and subsequent prominence of institutions such as the Federal Reserve System and the Federal Deposit Insurance Corporation. Through these institutions, the amount of credit in the system could be modulated, periodic waves of panic leading to bank runs could be eliminated, and if ever the occasional crisis should break out, the central bank could step in to serve as the lender of last resort. This system, once perfected, proved sturdy and effective.

But then banks began to lose their centrality. This occurred in many ways. On the liability side of bank balance sheets, for example, depositors seeking higher yields began to invest instead in securities, principally in the form of shares of money-market funds.<sup>46</sup> Money-market fund shares proved to be highly competitive substitutes for bank deposits.

On the asset side of bank balance sheets, the traditional model was similarly challenged. For example, at almost the same time the first U.S. money-market fund opened, the first mortgage-backed pass-through securities were issued. These readily transferable securities replaced loans held to maturity on bank balance sheets.<sup>47</sup> A bank that previously had used its deposits as the basis for extending mortgage loans could now originate mortgage loans, package pools of them into special-purpose off-balance sheet vehicles, and then sell off interests in those pools in the form of readily transferable securities, without the need for a continuing base of deposits to support them once sold.

The nearly simultaneous development of money-market funds and mortgage-backed securities was not, of course, an accident.

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the “private private market,” as contrasted with the 144A market). Because I seek here to sketch the trends of interest to us only in the broadest of terms, I ignore complexities such as these.

<sup>46</sup> Henriques, *supra* note 7, at C1. The first money-market fund in the United States was the Reserve Fund, established in 1970. Money-market funds, of course, have been regulated by the SEC since their inception.

<sup>47</sup> Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Joint Hearing Before the H. Comm. on Fin. Serv., 108th Cong. 61–63 (2003) (statement of Cameron L. Cowan, Chair, Legis. and Judicial Subcomm., American Securitization Forum).

The one caused the need for the other: banks losing deposits to money-market funds had a reduced deposit base with which to support holding loans to maturity. So banks needed recourse to mortgage-backed securities to maintain their business. The natural superiority of securities-centric finance in one realm led inevitably to securities-centric finance elsewhere.<sup>48</sup>

And over the last three-and-a-half decades securities markets have been extraordinarily successful in displacing banks. As of December 11, 2008, money-market funds held over \$3.75 trillion in assets<sup>49</sup> that, once upon a time, would likely have been deposited with banks and used as the basis for additional bank lending. And the combined face amount of mortgage-backed and other asset-backed securities outstanding exceeded that of United States Treasury securities around 2001,<sup>50</sup> with over \$4.5 trillion of agency-backed MBS outstanding at the end of 2007.<sup>51</sup> The markets for other forms of asset-based securities and for high-yield debt securities similarly experienced spectacular growth.

Not only has securities-centric debt finance invaded well into the territory previously occupied by bank-centric financing: innovations in securities-centric finance have sprung up to provide solutions to needs bank-centric finance never addressed at all, most notably in the case of the vast market for credit default swaps.<sup>52</sup>

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<sup>48</sup> As another asset-side example, about a decade later, the high-yield debt market developed, substituting readily transferable securities for unsecured business loans that previously would have been held to maturity by the lender. The market for newly issued high-yield debt grew rapidly after its inception from a base of only about \$2.7 billion in 1983. Dwight Asset Mgmt. Co., *Fixed Income Primer: High-Yield Bond Market 2* (2006), available at <http://www.dwight.com/pubs/dwightHighYield2006.pdf>. Here again, securities markets replaced banks and other financial institutions.

<sup>49</sup> Inv. Co. Inst., *Money Market Mutual Fund Assets* (Dec. 11, 2008), [http://www.ici.org/stats/mf/mm\\_12\\_11\\_08.html](http://www.ici.org/stats/mf/mm_12_11_08.html). Outstanding bank deposits were \$7.25 trillion on Dec. 10, 2008. Fed. Reserve Bd., *Statistical Release: Assets and Liabilities of Commercial Banks in the United States* (Jan. 30, 2009), <http://www.federalreserve.gov/releases/h8/Current/>.

<sup>50</sup> See, e.g., Thomas Zimmerman, UBS, *U.S. Mortgage Backed Securities Market* (Jan. 29, 2006), [http://www.americansecuritization.com/uploadedFiles/1-29-2006%20US%20MBS%20\(tom\).ppt](http://www.americansecuritization.com/uploadedFiles/1-29-2006%20US%20MBS%20(tom).ppt).

<sup>51</sup> Sec. Indus. & Fin. Mkts. Ass'n, *Agency Mortgage-Backed Securities Outstanding* (2009), <http://www.sifma.org/research/pdf/AgencyMortgageOutstanding.pdf>.

<sup>52</sup> At mid-year 2008, the notional amount of credit derivatives outstanding was approximately \$55 trillion. Press Release, Int'l Swaps & Derivatives Ass'n ("ISDA"), *ISDA Mid-Year 2008 Market Survey Shows Credit Derivatives at \$54.6 Trillion* (Sept. 24, 2008), available at <http://www.isda.org/press/press092508.html>. This figure

As securities centrism has displaced the traditional bank-centric model, the roles of investment banks and commercial banks not surprisingly have blurred together to the point that they may now be indistinguishable. On the one hand, commercial banking organizations have sought to operate more and more like investment banks.<sup>53</sup> Initially prevented by the Glass-Steagall Act of 1933<sup>54</sup> from operating as investment banks, commercial banks finally succeeded in achieving passage of legislation liberating them from this restriction in the form of the Gramm-Leach-Bliley Act of 1999.<sup>55</sup> On the other hand, in response to the recent market turmoil, Morgan Stanley and Goldman Sachs have converted to bank holding company status.<sup>56</sup>

The rise of securities-centric finance at the expense of bank-centric finance will not—and should not—be reversed. Global markets have spoken. The advantages securities-centric finance offers are too great. The clock cannot be turned back.

But, as securities-centric finance has grown to have systemic importance rivaling that of bank-centric finance, regulation simply has not kept pace. Cycles of credit boom and bust have been a “hardy perennial” since the outset of organized financial markets at the beginning of the seventeenth century.<sup>57</sup> The modern regulatory machinery in place to moderate these cycles, however, was built to deal primarily with bank-centric finance.<sup>58</sup> These arrangements regulate the capital of banks, regulate the extension of credit by banks, insure deposits at banks and, when all else fails, provide a sovereign central bank to act as lender of last resort.

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greatly exaggerates the economic significance of this market, however. The ISDA estimated the resulting aggregate net credit exposure before collateral to be only about \$2.7 trillion. *Id.*

<sup>53</sup> This is true even in the core banking business of secured lending to business enterprises, where the syndication of participations in credit agreements has become more and more difficult to differentiate from the distribution of bonds by underwriters.

<sup>54</sup> Glass-Steagall Act of 1933, ch. 89, § 20, 48 Stat. 162, 188 (1933), repealed by Gramm-Leach-Bliley Act, Pub. L. No. 106–102, § 101, 113 Stat. 1338, 1341 (1999).

<sup>55</sup> Gramm-Leach-Bliley Act, Pub. L. No. 106–102, § 101, 113 Stat. 1338, 1341 (1999).

<sup>56</sup> See Fed. Reserve Bd., *supra* note 18 and accompanying text.

<sup>57</sup> Charles P. Kindleberger, *Manias, Panics, and Crashes 1* (4th ed. John Wiley & Sons 2000).

<sup>58</sup> Margin regulation, however, is one example of a regulatory measure dealing with securities-centric finance motivated by systemic considerations.

The move from bank-centric to securities-centric finance renders these arrangements inadequate during both boom and bust. During boom, securities-centric finance may extend excessive credit without much sensitivity to efforts at modulation by central bank regulation. During bust, securities-centric finance needs not so much a lender of last resort,<sup>59</sup> but a “market-maker of last resort.”<sup>60</sup> For, as we have seen, any assumption that markets will always be open has proven false in spectacular fashion, as market after market has frozen up during the recent credit crunch. And securities-centric finance requires that attention be paid to the “safety and soundness” of key institutions participating in those markets, just as bank-centric finance paid attention to the safety and soundness of banks.

So, with securities markets displacing banks and the need for new regulation undeniable, is this not the place for the SEC in the twenty-first century? Unfortunately, no. Few of the pressing regulatory tasks at hand implicate core competencies of the SEC. Most pointedly, the SEC lacks a checkbook with which to prop up a failing financial system. The SEC’s role in responding to the credit crisis therefore has been—and could only be—mostly tangential. Instead, it has been the preeminent regulators of the bank-centric world, the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York, that have stepped forward to extend their funding capacity to the new securities-centric world. Lacking both the monetary tools and the skills of a central bank, the SEC has found itself on the sidelines.

Might there nonetheless be a role, albeit a lesser one, for the SEC in the new institutional markets that would permit the SEC to exploit its core competencies? Could the SEC make a future for itself providing to the new universe of institutional investors protections analogous to those the SEC previously provided to retail investors?

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<sup>59</sup> Though, to be sure, so long as bank-centric debt finance remains systemically significant, a lender of last resort continues to be a necessity.

<sup>60</sup> See Mark Carney, Governor, Bank of Canada, Building Continuous Markets, Remarks to the Canada-United Kingdom Chamber of Commerce (Nov. 19, 2008) (transcript available at <http://www.bankofcanada.ca/en/speeches/2008/sp08-14.pdf>).

In answering that question, one thing is clear: sophisticated institutional investors are different from retail investors.<sup>61</sup> Sophisticated institutional investors have highly professional staffs and substantial resources. They can hire outside firms and advisers. They have access to extensive information technology resources, and many have offices worldwide. It is no wonder retail investors choose to invest through institutional intermediaries rather than try to compete.

If institutional investors differ greatly from retail investors, then any regulations aimed at providing protections to institutional investors<sup>62</sup> must differ greatly from those aimed at providing protections to retail investors. In fact, ever since the exemption for private placements was carved out of the Securities Act of 1933,<sup>63</sup> the default alternative has been what I have termed “antifraud only” regulation.<sup>64</sup> For the SEC, unless it finds a new direction and emphasis, deretailization and the shift to institutional securities-centric debt financing would thus likely imply a continuing role for the Division of Enforcement—already the largest division of the SEC by far—but otherwise a mandate destined to continue to shrink over time.<sup>65</sup>

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<sup>61</sup> Some nominally institutional investors, however, are also unsophisticated and perhaps should not be treated as institutional investors for some regulatory purposes. For example, at least some instrumentalities of state and local governments would seem to fall into this category.

<sup>62</sup> As distinguished from regulations aimed at protecting the system *from* the collective consequences of the activities of institutional investors.

<sup>63</sup> Securities Act of 1933, ch. 38, § 4, 48 Stat. 74, 77 (1933) (codified 15 U.S.C. §77a).

<sup>64</sup> Cartwright, *supra* note 23.

<sup>65</sup> Professor Langevoort seeks to avoid this conclusion with three suggestions, which can be summarized, all too briefly, as follows: (1) maybe institutional investors do not in fact differ much from retail investors in the ways that matter, thereby justifying SEC interventions on their behalf; (2) maybe the point of the securities laws is not investor protection after all, but is “disconnected from shareholder or investor welfare”; and (3) whatever the merits, politics will intervene to maintain the status quo. Langevoort, *supra* note 21 at 1055–70, 1066, 1081–83.

My responses to these suggestions, in equally condensed form, are as follows: (1) assuming, *arguendo*, that this is true, SEC interventions remain unjustified unless the SEC can be shown to have greater competence or to be more efficient in the relevant dimensions than institutional investors in the aggregate, propositions not to be accepted without convincing justification; (2) the ultimate point of the securities laws is general prosperity (with investor protection as merely a means to that end), and, in seeking general prosperity, implementing the securities laws now for purposes other than investor welfare would seem a risky distraction at a particularly inopportune

*C. Globalization*

Globalization, the third long-term trend we need to consider, has been much remarked upon, including in Professor Langevoort's article.<sup>66</sup> So we need not tarry overlong on it. The rate of globalization of the securities markets over the last few decades has been truly extraordinary. For example, in 2007 the combined dollar volume of buying and selling by U.S. persons of foreign stocks was over \$10 trillion—over 200 times greater than it was in 1980.<sup>67</sup> Many investment advisers now counsel portfolio allocations to foreign securities as high as 50 percent.<sup>68</sup> Like deretailization and the shift to securities centrism, globalization of the securities markets has occurred because of compelling advantages to all concerned. Investors gain greater portfolio diversification and an opportunity to participate in growing enterprises anywhere in the world, including the developing world where over the long haul economic growth can be expected to significantly exceed growth of the relatively mature U.S. economy. Issuers gain access to a broader and deeper pool of capital. Like deretailization and the shift to securities centrism, globalization is a trend that is likely to continue—and it should.

The flip side of globalization, of course, is a proportionately reduced and more challenging role for the domestic securities markets and their regulator, the SEC. And the simultaneous trends toward deretailization and institutional securities-centric finance exponentially compound the effects of globalization on the SEC. Unlike retail markets, institutional markets are inherently global. Many large institutional investors maintain offices and subsidiaries overseas. If they find transacting business overseas more amenable to their purposes, they readily can do so. And the securities created by securities-centric finance travel easily across borders. As Professor Langevoort notes, where once the United States was dominant,

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time; and (3) it is always folly to underestimate the possibility that politics may intervene to achieve a suboptimal outcome.

<sup>66</sup> Langevoort, *supra* note 21 at 1070–80.

<sup>67</sup> See Brian G. Cartwright, General Counsel, Sec. & Exch. Comm'n, *The Role of the States (Foreign and Domestic)*, Speech at the Widener University School of Law (Mar. 28, 2008) (transcript available at <http://www.sec.gov/news/speech/2008/spch032808bgc.htm>).

<sup>68</sup> *Id.*



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“the United Kingdom is now a world leader in many segments of global finance.”<sup>69</sup>

*D. “Mathematicization”*<sup>70</sup>

There is yet a fourth trend that challenges the SEC’s future as a regulator of institutional markets. Only a few decades ago, to be a financial analyst required not much more than grade school arithmetic plus an understanding of how to calculate compound interest. But that changed forever with the 1965 publication of “The Behavior of Stock-Market Prices” by Eugene Fama.<sup>71</sup> That publication and others like it posited that the time evolution of market prices could be usefully approximated by a random walk, implying that the well understood mathematics of Brownian motion could be helpful in understanding market behavior. The mathematics involved, however, though not particularly sophisticated, was nonetheless well beyond the ken of most lawyers.

And then came the publication in 1973 of “The Pricing of Options and Corporate Liabilities” by Fischer Black and Myron Scholes.<sup>72</sup> Black and Scholes (“Black-Scholes”) initiated not only a river of follow-on academic literature that continues to this day, but also launched the modern derivatives markets. After Black-Scholes, investment banks began hiring Ph.D.s in physics and mathematics in volume. To be an effective practitioner in the derivative markets started to require mathematical expertise rarely found among lawyers. Understanding how market participants were valuing structured finance products—asset-backed securities, collateralized bond obligations, “CDO-squared” securities and the like—similarly required more sophisticated mathematics than all but a very few lawyers have.

But the SEC is an agency manned almost exclusively by lawyers and accountants, not by Ph.D.s with mathematical sophistication.<sup>73</sup>

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<sup>69</sup> Langevoort, *supra* note 21, at 1039.

<sup>70</sup> My apologies to Professor Langevoort for yet another “-ization.”

<sup>71</sup> Eugene F. Fama, *The Behavior of Stock-Market Prices*, 38 *J. Bus.* 34 (1965).

<sup>72</sup> Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 *J. Pol. Econ.* 637 (1973).

<sup>73</sup> The SEC does have an Office of Economic Analysis that includes a small number of Ph.D. economists with mathematical training. The tasks for which these economists are most frequently responsible include determining the dollar amount of damages

The SEC has not felt—or even been much aware of—the shift to mathematical finance because the new markets where mathematical sophistication is required generally have been institutions-only markets, reflecting deretailization and the inability of retail investors to compete in such an environment.<sup>74</sup> These markets have been only tangentially regulated by the SEC, if at all. But that is, after all, the point: the SEC as currently configured simply lacks the institutional competence to regulate these markets effectively.<sup>75</sup> Confronted with the manager of a derivatives trading operation explaining the workings of his or her business, few SEC staff could follow the discussion. How can you effectively regulate what you do not understand?

#### CONCLUSION

So whither the SEC now? The SEC's main historical focus and the key source of its rhetorical and political support is the protection of retail investors. Deretailization thus directly threatens the SEC's future. The shift to securities centrism has led to the explosive growth of new securities markets, but most of these markets are overwhelmingly or exclusively institutional markets. The need for regulation of these markets is pressing, but the primary need is for regulation addressing the aggregate level of credit and economy-wide systemic risk, regulatory interests outside the SEC's core competence.<sup>76</sup> Globalization further augments the power of institu-

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suffered by investors as a result of financial fraud in enforcement cases and assisting in the performance of cost-benefit analyses in rulemakings.

<sup>74</sup> The SEC's Inspector General currently is investigating the failure of the SEC staff to uncover the Ponzi scheme allegedly operated by Mr. Bernard L. Madoff, despite an extensive analysis provided to the staff by Mr. Harry Markopolos. Harry Markopolos, *The World's Largest Hedge Fund is a Fraud* (2005), available at [http://online.wsj.com/documents/Madoff\\_SECdocs\\_20081217.pdf](http://online.wsj.com/documents/Madoff_SECdocs_20081217.pdf). I believe it likely a lack of familiarity with modern finance will prove to have been a substantial factor in that failure.

<sup>75</sup> One of the SEC's long-term regulatory competitors, the Federal Reserve Board, by contrast, has hundreds of Ph.D. economists on its staff.

<sup>76</sup> Indeed, in many ways these regulatory interests conflict with the SEC's focus on retail investors. Regulators concerned with restarting the flow of credit and capital may find mark-to-market accounting procyclical and counterproductive, while the SEC must unwaveringly support mark-to-market accounting as helpful to investment analysis. Further, regulators concerned with systemic risk may find it counterproductive to exact settlements in the tens of billions of dollars from reeling financial institu-

tional securities markets and further constrains the SEC's freedom of action. And many of these new markets are built on a level of mathematical sophistication inaccessible to retail investors and foreign to all but a handful of the SEC's staff. These four trends are mutually reinforcing.

If deretailization threatens to shrink the SEC's traditional role; if the shift from bank-centric to securities-centric finance poses few, if any, new opportunities; if globalization constrains the SEC's freedom of action; and if mathematicization challenges its expertise; what then remains?

A great deal, in fact. The SEC's core competence is protection of the retail investor. As I have pointed out before,<sup>77</sup> increasingly that means protection of the retail investor with respect to investments in financial intermediaries, such as mutual funds and defined contribution pension plans. Professor Langevoort correctly evaluates the SEC's performance in this domain as mixed, at best. There is much new work to be done. The opportunities for dramatic improvements in retail investor welfare abound. Such challenges can—and should—excite and energize a new generation of SEC staff.

And for the turf-conscious among SEC supporters, there even is room to seek legislative expansion of the SEC's jurisdictional reach. The extraordinarily important investment choices of retail investors in 401(k) plans currently are the province of the Department of Labor ("DOL"), because ERISA<sup>78</sup> is administered by that Department. But surely retail securities investment is not within the core competence of DOL. The SEC, not DOL, should be regulating how 401(k) participants make investment choices. These choices are of pressing national concern; nothing less than the comfort and security of the nation's aging population in retirement is at stake.

In short, the SEC must follow the retail investor. If it does, the SEC should have a bright future. If instead it focuses on markets

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tions, while the SEC must obtain such settlements for retail investors stuck holding auction rate securities after that market failed.

<sup>77</sup> Cartwright, *supra* note 23.

<sup>78</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001–1461 (2006).

abandoned by retail investors, or if it seeks to expand into regulatory missions for which it lacks competence, it courts failure.

In this mission, the SEC will need the assistance of careful, thorough analysis. That is where academic lawyers—the readers of this *Review*—come in. Brilliant academics—and not just professors of law, but also professors of economics and behavioral psychology, among others—are needed to help provide the intellectual foundations for this work. Surely there must be splendid career opportunities for the young academic who focuses attention away from, for example, the by-now tediously familiar agency concerns in corporate governance to these far more productive and less thoroughly plowed grounds. Professor Langevoort suggests what is needed is the development of “a general theory or deep empirical knowledge about opportunism in the securities business.”<sup>79</sup> Is that not just what the freedom afforded academicians should be for?

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<sup>79</sup> Langevoort, *supra* note 21, at 1055.