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REGULATION AND INVESTORS' TRUST IN THE SECURITIES MARKETS*

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The subject of investor confidence in the securities markets has received wide attention recently as details of fraud and avarice continue to emerge. Investors' trust in the securities markets is important for the reasons discussed in Professor Stout's marvelous paper.[1] This Comment focuses on the relationship between investors' trust and government regulation of the markets. By regulation I mean congressional legislation and actions by federal agencies. I exclude the courts mainly because their lawmaking is not primarily policy-based, and my aim is to sound the alarm for legislative and regulatory policy-directed actions. Many an economist and academic have argued that regulation is costly for issuers and financial intermediaries.[2] Regulation, they say, is a barrier to capital formation, that is, to inducing savers to part with their money and invest in securities.[3] I assume that they are correct. Regulation does impose these costs, and the costs can be a barrier to raising capital for issuers.

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1 Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407 (2002).

2 *See, e.g.*, Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1345-46 (1999) (explaining types of costs issuers incur from information disclosure); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 934 (1998) ("For issuers, investors, and financial intermediaries, learning the regulations of a particular regime is costly.").

3 *See, e.g.*, SECURITIES AND EXCHANGE COMMISSION ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES, Final Report, app. A (July 24, 1996), *available at* http://www.sec.gov/news/studies/capform/capffull.txt (last visited Sept. 23, 2002) (noting that capital formation was hampered by the costs of the registration process).

But here is a puzzle. When market prices rise, one would assume that regulation can be stricter, because issuers can easily raise capital and bear regulatory costs. Yet, the opposite occurs. This is precisely when government regulation relaxes. When market prices fall, when investors avoid the markets, and issuers find it very difficult to raise capital, one would assume that regulation would be more relaxed to reduce the issuers' costs. Yet, the opposite occurs. This is precisely when government regulation becomes stricter. This is a puzzle.

There is much evidence that the government tightens regulation following market crashes and relaxes regulation as market prices rise. In the 1930s, there was no market to speak of, and the existing financial infrastructure did not work. Investors were gone.[4] Yet, during those years, Congress passed regulation that was unheard of in strictness and intrusion, as compared to existing state regulation that governed the field until then.[5] In 1970, after the market deflated from the bubble of the 1960s, Congress again amended the laws by tightening regulation,[6] and in 1975 Congress restructured the markets at a higher cost to the financial system.[7] Similarly, after the 1987

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[4] *See, e.g.*, S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683 (noting that Congress enacted the 1933 and 1934 Acts to promote investor confidence and thus encourage investment).

[5] Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77bbbb (2000)); Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78mm (2000)); Trust Indenture Act of 1939, ch. 411, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa-77zzz (2000)); Public Utility Holding Company Act of 1935, ch. 687, §§ 1-33, 49 Stat. 803, 803-38 (codified as amended at 15 U.S.C. §§ 79a-79z-6 (2000)).

[6] Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (codified as amended at 15 U.S.C. §§ 78aaa-78lll (2000)); Charity Scott, *A Broker-Dealer's Civil Liability to Investors for Fraud: An Implied Private Right of Action Under Section 15(c)(1) of the Securities Exchange Act of 1934*, 63 IND. L.J. 687, 738-39 (1988).

[7] Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15 U.S.C.); Walter Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755 (1984) (describing the changes in market regulation under the 1975 legislation); Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 562-63 (2000) (noting that "[i]n the early 1980s, when deregulation was in vogue, SEC staffing suffered. Unfortunately, the securities markets were just beginning an era of expansive growth. The SEC found itself seriously underfunded. The Reagan Administration's emphasis on deregulation, backed by incomplete scholarly exposes on the problems plaguing regulatory agencies, thus left financial markets woefully underpoliced at a critical time. Frauds of unprecedented magnitude resulted. . . . Prudential-Bache Securities fraudulently sold to thousands of retirees and other conservative investors, involving a web of scandal-ridden limited partnerships. Vast networks of nefarious insider trading festered in the darkness of deregulation. Though the costs of this debacle are difficult to calculate, the carnage in terms of real lives ruined is astounding." (footnotes omitted)).

crash, there was a flurry of activity by Congress and state legislatures.[8]

Today, some commentators bemoan what they consider to be excessive congressional regulation, especially from the 1930s. These commentators try to show that this body of regulation was wrong and costly.[9] Yet, in the 1930s or any other period of regulatory activism, few argued against regulation. In fact, issuers and intermediaries sought government regulation. What is interesting is *how* they sought regulation. On the one hand they clamored for it, and on the other they argued for watering down and restricting the impact of every regulatory provision, fighting all the way to congressional approval.[10]

This pattern has continued. In 1996, Congress divided regulatory authority over approximately 22,000 investment advisers, leaving the exclusive regulation of large advisers with the Securities and Exchange Commission ("SEC") and the exclusive regulation of numerous small advisers with the states.[11] The limited resources of the SEC were the main reason for this division. These limited resources would have covered the cost of examining each adviser about once every forty years.[12] The reaction of the small advisers is interesting and

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[8] *See* Jerry W. Markham & Rita McCloy Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L.J. 1993 (1988) (discussing the crash and proposals that followed it); Jonathan R. Macey et al., *Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash*, 74 CORNELL L. REV. 799, 822-23 (1989) ("Certain trading strategies, such as index arbitrage and portfolio insurance—commonly called program trading—have fallen under intense criticism since the October 19, 1987 market crash. . . . Calls for restrictions on program trading strategies and the derivative products that make them possible abound in Congress and the popular press. . . . [and] extend to the uptick rule because the uptick rule plays an important role in one type of program trading—index arbitrage." (footnotes omitted)).

[9] *See, e.g.*, Theresa A. Gabaldon, *Love and Money: An Affinity-Based Model for the Regulation of Capital Formation by Small Businesses*, 2 J. SMALL & EMERGING BUS. L. 259, 266-67 (1998) (noting that the mandatory disclosure provisions of the 1933 Act "[have] spawned substantial critical commentary").

[10] *See Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 76th Cong. 71-93 (1940) (statements of industry representatives supporting Investment Company Act of 1940); *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the S. Comm. on Banking and Currency (pt. 2)*, 76th Cong. 325-486 (1940) (statements of industry representatives expressing concerns about specific provisions of the Act).

[11] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, §§ 301-308, 110 Stat. 3416, 3436-40 (codified as amended in scattered sections of 15, 29 U.S.C.); S. REP. NO. 104-293, at 3 (1996) (noting number of SEC-regulated advisers before amendment).

[12] S. REP. NO. 104-293, at 3.

revealing. They vehemently opposed the change.[13] They wanted to continue to advertise themselves as "Regulated by the SEC," which they valued more than the advertising of "Regulated by State X."[14] Perhaps they were also concerned that state examiners would be visiting them more often than once every forty years.

I submit to you that the behavior of regulated financial institutions makes sense. They *benefit* from regulation. One benefit of regulation is reduced destructive competition. But that is not the main benefit. Regulation offers issuers and institutions government support in their efforts to gain investors' trust in the financial markets. Just as it is difficult to validate the trustworthiness of these institutions, it is also very costly for the institutions to convince investors of their trustworthiness. Regulation reduces the institutions' costs. Regulation also helps to restrain the "bad apples" that may ruin confidence in the industry; a few untrustworthy members may spoil the reputation for trustworthiness for all industry members. Regulation provides the industry with the stamp of "good housekeeping." It implies that the government guards investors' interests, and reduces the very high costs that investors would otherwise bear in monitoring the issuers and the institutions.

Matthew Fink, president of the Investment Company Institute (the trade association of mutual funds' advisers), recently stated that "the lack of panic exhibited by fund investors [after the recent crash] is a direct result of their confidence in the industry's commitment to investor protection through regulation and self-policing."[15] It remains to be seen whether his comfort will continue after the recent revelations and scandals. As for Congress, it makes sense for legislators to act when the market crashes. A market crash draws national attention. That is when regulators feel compelled to show their voters/investors that they care, and are committed to "do something" about investors' losses.

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[13] This statement is based on my observations when I was an Attorney Fellow at the Securities and Exchange Commission during the legislative changes, in 1996-1997.

[14] *SEC Oversight of Investment Advisers: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Hous., and Urban Affairs*, 102d Cong. 119 (1992) (statement of Richard C. Breeden, Chairman, SEC).

[15] *Welcoming Remarks*, INVESTMENT COMPANIES & INVESTMENT MANAGERS (Sidley Austin Brown & Wood LLP, New York, N.Y.), Apr. 2002, at 1, 1, *available at* http://www.sidley.com/db30/cgi-bin/pubs/JPG-72.pdf (last visited Aug. 23, 2002).

But why do congressional leaders believe that holding public hearings and tightening regulation signals their investor constituencies that Congress is "doing something"? Legislators must believe that stricter laws are meaningful to the investors and will restore their trust in the market system. Otherwise legislators—the investors' representatives—would not engage in passing such laws.

It is hard to separate investors' waning trust from investors' disappointment and frustration at their losses and from other reasons that may induce them to sell their shares and cease investing in the markets. But I rely on the judgment of the financial institutions and Congress. In their different spheres, each is closest to investors. It is their judgment and their actions that I cite as evidence for the proposition that investors' trust is crucial to the existence of financial markets, especially when prices fall, and that regulation can revive this trust. Theoreticians may reason to the contrary. I put my trust in the judgment of Congress and the financial institutions.

But why is regulation less meaningful to investors during rising markets and more meaningful during, or immediately after, a crash? Here I offer a speculation of my own: prices for investors are surrogates for the integrity of the market. Prices are efficient indicators. People tend to rely on clear, specific signals rather than on probabilities.[16] This may be one of the reasons for the momentum of runs or bubbles that cause sharp price rises and declines. When prices rise, investors believe, rationally or irrationally, that the system is fair to them and that it works well.[17] But when the market crashes and investors lose significant amounts of money, they begin to seek explanations for these losses. Even investors who blame themselves for their bad judgment cannot avoid a suspicion that something wrong in the system caused the crash. Losing investors suspect that the system allowed

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[16] *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 263 (1979) (suggesting that the utility theory is inconsistent with actual choice under risk which people make: "[P]eople underweigh outcomes that are merely probable in comparison with others that are obtained with certainty. This tendency, called the certainty effect, contributes to risk aversion in choices involving sure gains and to risk seeking in choices involving sure losses.").

[17] I hypothesize that investors care about the integrity of the market system. They care about a fair, not necessarily a level, playing field. They are not willing to play with loaded dice. They are willing to lose fair and square but not to be taken by fraud. Investors also hope to gain both from the rise in the fortunes of the American economy and from their good judgment about issuers.

someone to gain at their expense. They begin to question the integrity of the system, and their trust falters.

In orderly markets, some investors believe that it is a good time to sell and others believe that it is a good time to buy. A run on the markets may be propelled, among other things, by the belief of many investors that it is a good time to sell and not a good time to buy. One reason for mass selling is an uneasy feeling that the system is unfair to investors. This belief may continue after the avalanche, and few investors will buy until the pains of the crash and losses have faded from recent memory.

Financial institutions and regulators respond to the weakening trust in the markets by assuring investors that their suspicions are unfounded. One can analogize the trustworthiness of the system to reputation. To reap future benefits from the financial markets, financial institutions and Congress invest in building up the markets' reputation for trustworthiness. But when times are good, Congress and the industry overconsume the fruit of a good reputation and deplete its value. When events lead investors to question the system's trustworthiness, Congress, the issuers and the industry start to repair the damage and invest in market reputation again. When investors' trust is restored, industry pressures increase to reduce the cost of capital formation. Investors do not seem to mind. Regulation is relaxed. And when prices fall, the cycles start all over again.

Congress, the issuers and the industry should learn what private sector corporations know so well in the context of their businesses. Deplete your reputation with shoddy goods and you are bound for lean years of meager profits and high investment to shore up your reputation. The benefits from the depletion may or may not be worth it. Congress, the issuers and the industry knew this lesson after tightening regulation in the 1930s and 1970s. But as leaders of these institutions came and went, institutional memories seem to have dimmed. This leads to my second observation and another series of questions.

As Professor Stout well documented, securities regulation today is more lax than the regulation in the 1930s or even the 1970s.[18] For the past thirty years, notwithstanding periodic runs on the securities markets, Congress has been

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[18] Stout, *supra* note 1 at 432-36.

relaxing regulation. Yet, the flight of investors from the markets has not been as stark as in the 1930s. Has the market system become fairer? Perhaps. Has corporate management become less greedy? Maybe. Have financial institutions become more trustworthy? Could be. Have investors developed a habit of trusting the markets? Possibly. But there are two more explanations that I offer.

I call the first explanation the "golden handcuffs." Since the mid-1970s, the United States government has provided tax deferrals to savers who invest in the securities markets. In 1974, the Employee Retirement Income Security Act[19] required employers to fund their pension fund obligations, and this funding took the form of investments in securities. Then employers passed the benefits and risks of investments to employees. Employees also invest their savings in securities and, often, in mutual funds. Self-employed savers have been granted tax benefits. They, too, invest in the markets and with mutual funds.[20] The amounts of these investments are very large. Some say about 35% of the market.[21]

When the market crashes, these investors are locked into these tax deferral benefits. If they sell the securities and withdraw the proceeds, they must pay the deferred taxes. Further, any income from an investment they make with the proceeds will be immediately taxable. Therefore, persons with a life's savings in mutual funds would think more than twice before withdrawing their money. In addition, the potential tax rate on withdrawal may be higher than the rate they are currently paying. Retirees in low tax brackets will fall into a higher tax bracket on withdrawal of large sums in a short period. Thus, many investors cannot leave the markets without paying a heavy penalty—taxes for the past and perhaps giving up future tax benefits.

My second explanation is that many investors *do* leave the markets, but not ostentatiously. In the past, they fled the equities markets by selling their securities and depositing the money in the banks. Today, they flee the equity funds to the money market funds. These funds invest not in equities or

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[19] Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 (2000)).

[20] *See* I.R.C. §§ 403(b), 401(k) (2000).

[21] *Mutual Funds and the Retirement Market in 2000,* FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), June 2001, at 1, 2, *available at* http://www.ici.org/pdf/fm-v10n2.pdf (last visited May 30, 2002).

corporate bonds, but in bank and government securities. This money feeds bank loans. Bank loans feed borrowers, by debt. Bank lending is usually more conservative. Some of the debt is securitized but reaches a different market, one populated mainly by financial institutions. Bank purchases may be more conservative, because bankers do the due diligence, not the accountants, lawyers and underwriters. Thus, the trend is away from corporate securities and especially from equities, and away from market "due diligence," to bank "due diligence."

The transfer of investments from equity funds to money market funds assures mutual fund advisers and other money managers a continued business, if not as managers of equity funds, then as managers of money market funds, although that business may not be so profitable. Today, the move from equities to bank obligations and back is more efficient—it takes one phone call to move the money from one fund to another. Some long-term investors leave some investments in equities. Therefore, it is not so clear that investors are leaving the markets. The integrity of the system seems to remain intact even after a crash.

The result of this scenario is that today, regulators do not react to falling prices with the same alertness, alacrity and concern with which they reacted in the past. They need a jolt of more direct evidence to demonstrate cracks in the trust foundation, such as scandalous frauds perpetrated by the leaders of the issuers and shocking discoveries of avarice of the market gatekeepers—the accountants, lawyers and investment bankers. Most importantly, legislators need to be jarred by truly outraged investors. It is a pity they wait so long.

I agree with Professor Stout that it is a mistake to assume a solid investor trust in the markets today.[22] The signals of failed trust are loud and clear. They are simply delivered in a new form. But then, why worry? Even if investors' losses are significant and the scandals are sufficiently shocking, and even if investors scream in frustration, all that will happen is that market prices will fall and the capital formation for unreliable issuers will rise. That will teach issuers to be trustworthy. Market discipline will take over and perhaps do a better job.

Unfortunately, the markets, that is investors, do not necessarily provide the discipline. Investors seek to reduce

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[22] Stout, *supra* note 1, at 436-37.

their monitoring costs. They can follow each other's actions or some analysts' recommendations, and at the end, they can leave the markets altogether, a "run." These may be irrational behavior patterns, but these patterns have occurred for decades. The danger is that even if investors do not withdraw their money from the securities markets they will *cease to continue investing* in securities. The mutual fund industry seems to sense this danger because it is looking for new markets abroad.[23] The competition among the mutual fund advisers is becoming fiercer.[24] I trust the industry's judgment.

Another ambiguous signal of investor confidence is demonstrated by activity in other markets. Even as the prices of securities continue to fall, real estate markets seem to hold and even to rise. Additionally, the price of gold has climbed. I wonder whether the savings that used to head for the securities markets are not diverted to real estate, gold and other alternative investments.

If investors' trust wanes, and if their distrust deepens for some time, it may take more than strict government regulation to bring them back. That something may be a change in our current culture. Today's culture covers up theft. Managers of public companies, trustees, money managers and pillars of society are not faulted for using other people's money as their own. Those who get away with it are viewed enviously as smart. If investors are hurt sufficiently hard and long, they may cease to envy their disloyal managers and advisers, and instead turn their backs to them, and treat them as outcasts, worse than common thieves.

Therefore, if we want investors to remain in the markets, the attitude of those who control other people's money must change. Money managers must shift their attitudes to simple honesty. The markets, whatever they are, and the investors themselves will not effect the change. I fear that those who expect investors to distinguish between honest and dishonest managers are in for a bitter disappointment. While the burden is shifting to the investors to protect themselves, and caveat emptor is not far behind, investors may indeed

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[23] *See Global Development*, Investment Company Institute, *at* http://www.ici.-org/newsroom/industry_issues_global.html (last visited Aug. 21, 2002) (listing items of Investment Company Institute's "international agenda" which would facilitate sale of U.S. funds in foreign countries).

[24] *See* Tom Lauricella, *Fee Bitten: American Express Targets Outsider*, WALL ST. J., June 7, 2002, at C1.

protect themselves, but not in the way the issuers and industry expect.

I doubt whether investors will commit their valuable attention and time to judge the difference between honest and dishonest corporate management and financial intermediaries. I doubt whether investors will rely on advisers to make the distinction, once investors lose their trust in the market intermediaries. From the investors' point of view, it is more efficient to withdraw their savings from the markets. Unless we quickly develop a culture of honesty, and persuade investors that their mistrust is unjustified, I believe investors will judge *all* to be dishonest, including the issuers' management, financial intermediaries, investment advisers, brokers, underwriters and trustees.

When investors' trust is lost, efficient markets will shrink and become less liquid, and the cost of capital will rise. Other less efficient, but more trustworthy, forms of intermediation are likely to take over. Or investors will return to other types of investments, like real estate, gold and the like. They will seek investments they can see, evaluate and guard for themselves. As investors learn self-reliance, as costly as that might be, and have no need to trust, as efficient as that might be, they will leave the markets behind them, to the detriment of us all.