Comments on Lynn A. Stourt's *The Investor Confidence Game*

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I agree heartily with Professor Stout’s basic thesis that as the game plays on Wall Street, investors’ faith in the supposedly unbiased recommendations of the brokerage houses will trump information about traded companies every time when the intrepid explorers of finance go out to discover the prices. Of course, most people do not approach money rationally. Only economists, and not all of them, could believe otherwise. For years, the most influential pieces of information in the securities markets have been the estimates by the sell-side analysts, including these silly price targets. Regulation FD, for which ignorant and self-interested people trashed Art Levitt, keeps the analysts from accompanying their estimates with winks and nods indicating insider information, but there is still a lot of trust out there. The assertion in academia that people willingly make themselves vulnerable when they trust
others does not advance our understanding of the entire brokerage industry as we know it. Having brushed aside as old-fashioned concerns about conflicts of interest that were the subject of congressional attention and SEC reports as long ago as 1935, the industry was organized to exploit the fact that trust makes people vulnerable. The words “trust me” are for experienced people a source of concern, not confidence. As one of the heroes of the current leaders of the law and economics movement liked to say, “Trust—but verify.”

There is, of course, a reward for an acceptance of vulnerability: trust saves a lot of expense. Information costs; trust is free—in the short term. The way people who know better than the analysts make money is not by contrarian selling, but by joining the mob early and getting out sooner. Professor Romano’s notion that informed investors will not buy fraudulently promoted stock is naïve. Of course they will buy fraudulently promoted stock, as long as they think they can get out while other people are still piling in. Much of the time, of course, these bubbles are not fraudulent, just enthusiastic. An issue of the Economist last spring featured a little story about the stock of a temporary employment firm that had run up and then down; a bank analyst who had followed the stock said that the CEO of the company “became intoxicated with the echo from Wall Street of his rhetoric.” Where does efficient market and rational expectations theory put the stock priced by intoxicated recipients of the echo from Wall Street? Perhaps with Barnum’s insight that “there’s a sucker born every minute.”

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9 In a Ditch, ECONOMIST, April 13, 2002, at 62 (quoting Charles Gunther, who analyzes the company Labor Ready’s shares for Wells Fargo).

10 This quotation is attributed to P.T. Barnum. THE COLUMBIA WORLD OF QUOTATIONS (1996), available at http://www.bartleby.com/66/19/5619.html (last visited
Incidentally, it’s crazy to argue, as Merrill Lynch now does, that the registered representatives should not own the stock they tout.\textsuperscript{11} I want them to own what they push at me. The rule I want is that they and their firms can’t sell the shares we both own until after they’ve told me that that they plan to do so. And in the meantime, I want mandatory publicity for all hedging activity—equity and credit derivatives—that gives the bank or the broker an interest adverse to the interests of the holder of the securities they have sold her.

It is quite true, of course, that without some level of trust, public securities markets would be impossible. Indeed, the trust and the need for it go a good deal deeper than Professor Stout suggests. The truth is that you don’t own the stock you buy. It is owned by Cede & Co.,\textsuperscript{12} an organization of which you have probably never heard in your life, that owns much of America—$23 trillion worth of paper, last I looked. Cede & Co. is the nominee of the Depository Trust Co. (“DTC”), which clears all securities transactions and many transactions in municipal and asset-backed paper.\textsuperscript{13} For example, when you as a customer of, say, Morgan Stanley buy a few hundred shares of some company from a customer of, say, Charles Schwab, the transaction, verified by the brokers or their clearing agents, creates two contracts. One is between Morgan Stanley and the National Securities Clearing Corporation (“NSCC”), by which NSCC promises to deliver shares to Morgan, and Morgan promises to pay for them, on the third day after the trade.\textsuperscript{14} The other is a contract between the NSCC and Schwab, by which Schwab promises to deliver the shares to NSCC, which in turn promises to pay Schwab.\textsuperscript{15} The shares themselves, however, will never move. They are immobilized in the vaults of the DTC, in the name of Cede & Co.\textsuperscript{16}

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\textsuperscript{14} See generally 23A JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 8 (2001).

\textsuperscript{15} 23A id.

\textsuperscript{16} 23A id.
When the time comes to settle the trading of which your transaction was a part, NSCC adds up all of Morgan's transactions in the traded company's stock and arrives at a number, adding to or subtracting from the total number of shares of the stock owned by Morgan and its customers (and the other brokers for which Morgan clears).\(^7\) This means that Cede & Co. acknowledges that it owes Morgan a certain number of shares. Meanwhile, Schwab gets another message from NSCC, informing the firm of the change in its right to claim shares from Cede & Co. NSCC, which was once owned by the New York Stock Exchange but is now a subsidiary of DTC, also tells the brokers how much cash they must pay to or will receive from DTC as a result of that day's work.\(^8\)

The traded company does not know you own its shares.\(^9\) Neither does Cede & Co., or DTC or NSCC. As they used to say in the hair-dye ads, only your broker knows for sure. The traded company, which issued the shares you think you own, will communicate with you through your broker. Your broker will credit your account with dividends and order printed material—annual and quarterly reports and the like—from Automatic Data Processing, which has a printing plant the size of several football fields halfway out on Long Island to supply such goods to American industry.\(^10\) DTC is very careful about who is permitted to use its facilities, and—together with the stock exchanges, the National Association of Securities Dealers, the Securities Industries Automation Council and the banks that are the trustees for the mutual funds—it polices the safety, soundness and accuracy of the record-keeping of the brokerage houses. All this traces back to the bad old days of the early 1970s, when brokers were still delivering shares of stock endorsed by the previous owner to transfer agents who would issue new stock to the new owners; little old men carrying lawyers' redwells delivered securities and cash to the cages of the brokerage houses; settlement was in five days and transactions often didn't close for many days after that; and many transactions never really closed at all because papers got lost. If you're going to settle in three days—and now the

\(^{17}\) 23A id.


\(^{19}\) Id.

\(^{20}\) See, e.g., Robert C. Apfel, New Developments in Bondholders Communications, 1098 PLJ/Corp. 453, 505 (1999).
industry commitment is to settle trades the next day, T+1—
(and the commitment survives though a recent securities
industry association announcement said, please, not yet)—you
can’t have stock certificates drifting around.

That is the world we live in. Why does it make sense to
trust the people who operate this world, but not to trust the
traders and issuers of securities?

In the last twenty years, the market and the law
generated a set of perverse incentives. Thirty years ago, Albert
Hettinger, already a very old man, the balance wheel of Andre
Meyer’s Lazard Freres, said to me that the “[m]ost influential
teacher I ever had was the fellow who taught me accounting.”
His teacher used to say, “Accounting is a way to tell the
truth.” I commented then that it would be a pity if that idea
died out with his generation, but it did, and it’s a pity. The
accounting firms are not to be trusted because the way they got
business from corporate America, at least until quite recently,
was by helping companies cheat on their balance sheets, cheat
on their P&L, cheat on their taxes and cheat on their annual
reports. The accounting firm that was most creative in
conveying false impressions would get the most clients and the
biggest fees. It is called consulting. Nobody gets punished for
aiding and abetting fraud. The Andersen partners who helped
Waste Management lie to the market remained Andersen
partners; at least one of them got promoted.

Those who think law firms are different—that law firms
don’t sell themselves to clients as assiduous searchers for
arguably legal ways to evade the intent of the law—are invited
to seek absolution from Cardinal Law. Everybody’s entitled to
a mistake if he will confess it.

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21 Albert Hettinger was a professor of economics at Harvard University in the
1920s. He spent most of his career as a partner at Lazard Freres. Among his
pioneering insights was a prescription to invest in six or seven companies and never to
2002, at 76.
23 Id. at 339.
25 Id.; see also Delroy Alexander et al., Civil War Splits Anderson, CHI. TRIB.,
Sept. 2, 2002, at A1 (discussing the proceedings against Andersen partners following
the Waste Management scandal and the subsequent promotion).
26 Cardinal Law is the embattled leader of the Catholic Church in Boston,
Massachusetts who, in light of the pedophilia scandal rocking the Catholic Church,
found himself asking for forgiveness from his parishioners as much as offering them
absolution. See Profile: Cardinal Bernard Law, BBC NEWS ON-LINE, Apr. 29, 2002,
available at http://news.bbc.co.uk/1/hi/world/americas/1957915.stm (last visited Sept. 5,
Let me note that it is simply not true that the world was always like this. In some ways it was worse, but in others—especially the sense of pride of the autonomous professional—it really was better. Paul Cravath urged a White House committee to write legislation banning the sort of railroad reorganization work that had made him rich, because it enabled the bankers as bondholders to expropriate the poor devils who had bought that stock from these same bankers a few years before. Elihu Root liked to say that half the business of any good lawyer was telling his clients they were damned fools and should stop. Andrew Carnegie considered Elihu Root his counselor; conversely Jack Welch, to pull a name from the hat, shopped for lawyers by asking his general counsel to buy legal services. You can shop for and buy legal services on the Internet now, from big law firms.

On Wall Street in the old days, “registered representatives” were “customers’ men,” who took their customers with them when they moved from job to job, whose prosperity rested on their customers’ prosperity and who rewarded trust with loyalty—not all, by any means. Customers’ men were compensated by commissions, and some would churn the account. Some—in my experience, many—knew little about the market or the economy and spent most of their time acquiring and dispensing gossip. But if the firm that

28 Paul Cravath, the key figure in the development of the law firm Cravath, Swain and Moore, was known for his genius for organization, leadership and corporate law. See 1 ROBERT T. SWAINE, THE CRAVATH FIRM 573-76 (1946).
30 Elihu Root, a recipient of the Nobel Peace Prize, held a number of prestigious legal and political positions including U.S. Attorney, U.S. Senator, Secretary of State and Secretary of War. See DAN MORRIS & INEZ MORRIS, WHO WAS WHO IN AMERICAN POLITICS 500 (1974).
34 See, for example, http://directory.findlaw.com, an Internet attorney database.
employed them had asked them to sell their customers junk securities because the underwriting department had to dispose the stuff, they would tell the firm to go to hell.

Don Regan reorganized Merrill Lynch and gave up the interest on customer free balances—the largest single source of income for Wall Street brokerage houses in the 1960s—to break the stranglehold of the customers’ men.\textsuperscript{36} There are gains as well as losses in the new dispensation, but we have been careless about the incentives we create. After the Bankers Trust-Procter & Gamble fiasco,\textsuperscript{37} the Federal Reserve Bank of New York joined with the swap dealers’ associations to write a code of conduct in the derivatives market.\textsuperscript{38} The code of conduct they wrote was premised on the notion that all the participants in these markets are sophisticated people. Thus, the rule should be caveat emptor: if a derivatives dealer tells you he’s trying to help you solve your problem, don’t believe him.\textsuperscript{39} If you can’t trust your banker who says he is giving you ways to avoid interest rate risk, why should you trust anybody except the operations people.

Of course, we don’t want volumes and discs of law that people in markets have to consult every time they do business. We want a sense of fiduciary obligation; we want what Melvin Eisenberg called “social norms.”\textsuperscript{40} Professor Eisenberg had the bad luck of publishing in 1999, when it seemed reasonable to say that “[t]he common experience of informed observers is that the level of directorial care has risen significantly in the last ten years or so; that directors today are more attentive to their responsibilities.”\textsuperscript{41} Now we know that the major task of directors in the second half of the 1990s was to approve the issuance of stock options that quadrupled in value over the five years, from $26.5 billion a year to more than $110 billion a year—\textsuperscript{42}—not, of course, charged as an expense, and not deducted

\textsuperscript{36} Donald T. Regan, A View from the Street 129-31 (1972).
\textsuperscript{37} See Kelley Holland et al., The Bankers Trust Tapes, BUS. WK., Oct. 16, 1995, at 106.
\textsuperscript{39} Id.
\textsuperscript{40} Melvin A. Eisenberg, Corporate Law and Social Norms, 99 COLUM. L. REV. 1253 (1999).
\textsuperscript{41} Id. at 1266.
from profits after the accounting firms, Congress, the White 
House and even the SEC denounced the Financial Accounting 
Standards Board for proposing a commonsense rule requiring 
the valuation and expensing of such options. Last spring, 
Holman Jenkins, Jr., proposed in the Wall Street Journal that 
the investment banks spin off their research departments to 
advertising agencies, since the research departments are in the 
advertising business anyway.⁴³

But that doesn't solve the problem: people trust 
advertising, too. The question now is how do we eliminate the 
perverse incentives, how do we cultivate social norms that 
motivate accountants and analysts to attempt to present what 
the British call fair and true statements of corporate activity.⁴⁴
In the chicken-and-egg argument between law and social 
norms, clearly law has the better case. It is through the 
internalization of rules that people achieve obedience to social 
norms. And if we are going to have a rule of law, as Justice 
Robert Jackson once observed, we will have to have some law.⁴⁵
And we should, as Professor Stout argues, “pay attention to the 
needs of the trusting investor.”⁴⁶

⁴³ Holman W. Jenkins, Jr., Don't Shoot the Analysts; Spin 'em Off, WALL ST. J., Apr. 17, 2002, at A21.