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The Trouble with Investment Banking: Cluelessness, Not Greed

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The Trouble with Investment Banking: Cluelessness, Not Greed

WILL BUNTING*

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I. THE WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2010

On December 11, 2009, the U.S. House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009.¹ On May 20, 2010, the U.S. Senate passed the Restoring American Financial Stability Act of 2010.² At the time this Article was written, the Senate and the House were still to meet in a conference committee to reconcile the differences between the two reform bills. The two policy proposals of particular concern here are (1) section 103 of the Investor Protection Act, as set forth in House Bill 3817,³ and (2) proposed legislative language by the Obama administration to implement the so-called Volcker Rule.⁴

A. Section 103 of the Investor Protection Act

On June 17, 2009, the Obama administration introduced its white paper *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (Treasury White Paper), proposing significant and comprehensive regulatory reform in response to what it identified as the “most severe financial crisis since the Great Depression.”⁵ The Treasury White Paper offered specific recommendations

1. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2010) (enacted).

2. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010) (enacted).

3. Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 103 (2010).

4. See Phil Mattingly & Rebecca Christie, *Obama Sends ‘Volcker Rule’ Proposal on Bank Trading to Congress*, BLOOMBERG (Mar. 3, 2010, 20:17 EST), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ahiprjVlhV5w&pos=9>. The proposed legislative text addressing the Volcker Rule can be found at *Amendment to the Bank Holding Company Act Regarding the Size of Institutions and the Scope of Bank Activities*, U.S. DEP’T OF THE TREASURY (Mar. 3, 2010), <http://www.treasury.gov/initiatives/Documents/amend.final.-3-3-10.pdf> [hereinafter *Volcker Rule*].

5. U.S. DEP’T OF THE TREASURY, *FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 2* (2009) [hereinafter

intended to address five key goals: (1) promote robust supervision and regulation of financial firms, (2) establish comprehensive supervision and regulation of financial markets, (3) protect consumers and investors from financial abuse, (4) improve tools for managing financial crises, and (5) raise international regulatory standards and improve international cooperation.⁶ With respect to this third goal, measures aimed at strengthening the existing framework for investor protection by concentrating on principles of fairness were set forth; specifically, the Obama administration would insist that broker-dealers, who provide investment advice regarding securities to retail investors, have the same fiduciary duties and obligations as registered investment advisers, in this way harmonizing the legal framework applicable to what are perceived as “virtually identical” financial actors.⁷

Six months after issuing this proposal, Congress proposed section 103 of the Investor Protection Act,⁸ titled “Establishment of a Fiduciary Duty for this Brokers, Dealers, and Investment Advisers, and Harmonization of Regulation,” which would amend section 15 of the Securities Exchange Act of 1934 (Exchange Act)⁹ by adding a new subsection, (k), styled “Standard of Conduct,” providing that the Securities and Exchange Commission (SEC)

shall promulgate rules to provide that, with respect to a broker or dealer, when providing personalized investment advice about securities to a retail customer¹⁰ (and such other customers as the [SEC] may by rule provide),¹¹ the standard of conduct for such broker or dealer with respect to such customer shall be the same as the standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940.¹²

TREASURY WHITE PAPER], available at http://www.treasury.gov/initiatives/wst/Documents/FinalReport_web.pdf.

6. *Id.* at 2–4.

7. *See id.* at 71.

8. H.R. 3817 § 103.

9. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78oo (2006)).

10. For the purposes of section 103 of the Investor Protection Act, Congress proposed defining the term *retail customer* to mean “a natural person or the legal representative of such natural person, who (A) receives personalized investment advice about securities from a broker or dealer; and (B) uses such advice primarily for personal, family, or household purposes.” H.R. 3817 § 103(a)(1)(B).

11. The Investor Protection Act thus goes further than the Treasury White Paper insofar as it states that the SEC shall have authority to regulate a fiduciary duty standard owing to customers other than just retail customers. *See id.*; *see also* TREASURY WHITE PAPER, *supra* note 5, at 63.

12. H.R. 3817 § 103(a)(1)(B). The final Senate bill abandoned this rulemaking and instead took the more conservative approach of recommending additional studies into whether the House proposal was feasible. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 913 (2010). The present Article can be viewed as a small part of such future study.

Section 103 of the Investor Protection Act would similarly amend section 211 of the Investment Advisers Act of 1940 (Advisers Act)¹³ by adding a new subsection, (f), also styled “Standard of Conduct,” providing as follows:

The Commission shall promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customer (and such other customers as the Commission may by rule provide), shall be to act [solely]¹⁴ in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice.¹⁵

The Investor Protection Act, however, takes a further step, not contemplated by the Treasury White Paper, in proposing to endow the SEC with authority to regulate not just disclosures of securities products sold by broker-dealers and investment advisers but also the “merits” of the underlying transaction as well and the merits of the sales practices and compensation structures associated therein. In particular, section 103 would amend section 15 of the Exchange Act by adding new subsection (l) and section 211 of the Advisers Act by adding new subsection (g), both styled “Other Matters,” providing as follows:

The Commission shall: (1) facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers, and investment advisers, including any material conflicts of interest; and (2) examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors.¹⁶

1. The Applicable Fiduciary Standard for Broker-Dealers and Investment Advisers Will Likely Be the Same

Because broker-dealers have generally not been held to a fiduciary standard, and because most causes of action brought by investors against broker-dealers claiming a violation of the fiduciary duty owed to them

13. Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1, -21 (2006)).

14. Certain draft language put forth by the Obama administration contains a stricter “sole interest” test. *Title IX—Additional Improvements to Financial Markets Regulation § 913*, U.S. DEP’T OF THE TREASURY (July 10, 2009), <http://www.treasury.gov/press-center/press-releases/Documents/tg205071009.pdf>.

15. H.R. 3817 § 103(a)(2) (2010).

16. *Id.* § 103(a)(1)–(2).

have been arbitrated—and therefore are not published—there exists minimal guidance as to what this fiduciary duty for broker-dealers might look like in practice.¹⁷ Although some advocates of financial reform have suggested creating a new fiduciary standard that would apply with equal force to broker-dealers and investment advisers alike,¹⁸ statements made by various SEC commissioners and other commentators suggest that regulators will simply include broker-dealers within the Advisers Act by effectively repealing the current provision of the Act expressly excluding broker-dealers from its regulatory span.¹⁹ This interpretation would be consistent with language in the Treasury White Paper contending that the standard of care applicable to broker-dealers should be raised to a fiduciary duty standard in order to “align the legal framework with investment advisers.”²⁰

B. *The Volcker Rule*

On March 3, 2010, the U.S. Department of the Treasury proposed legislative language to implement the Volcker Rule, which would, in amending the Bank Holding Company Act of 1956²¹ by adding sections 13 and 13a, serve to limit proprietary trading by banking institutions and constrain the overall size of financial companies.²²

17. See Matthew P. Allen, *A Lesson from History, Roosevelt to Obama—The Evolution of Broker-Dealer Regulation: From Self-Regulation, Arbitration, and Suitability to Federal Regulation, Litigation, and Fiduciary Duty*, 5 ENTREPRENEURIAL BUS. L.J. 1, 54 (2010).

18. See, e.g., Elisse B. Walter, Comm’r, U.S. Sec. & Exch. Comm’n, Speech at the Mutual Fund Directors Forum Ninth Annual Policy Conference: Regulating Broker-Dealers and Investment Advisers: Demarcation or Harmonization? (May 5, 2009), available at <http://www.sec.gov/news/speech/2009/spch050509ebw.htm> (“Congress should throw both statutes on the floor, select what is best in each and cover any holes through which the floor boards show.”).

19. See, e.g., Blaine F. Aikin, *SEC’s Aguilar Urges Fiduciary Standard*, INVESTMENT NEWS (June 7, 2009), <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/2009/0607/REG/306079996> (“There is only one fiduciary standard, and it means that a fiduciary has an affirmative obligation to put a client’s interests above his or her own.”). But see Luis A. Aguilar, Comm’r, U.S. Sec. & Exch. Comm’n, Speech at the Investment Advisers Association Annual Conference: SEC’s Oversight of the Adviser Industry Bolsters Investor Protection (May 7, 2009), available at <http://www.sec.gov/news/speech/2009/spch050709laa.htm> (rejecting harmonization and analyzing how brokers who provide advice should be treated).

20. TREASURY WHITE PAPER, *supra* note 5, at 71.

21. 12 U.S.C §§ 1841–1850 (2006).

22. See *Volcker Rule*, *supra* note 4; Mattingly & Christie, *supra* note 4.

*1. Prohibition of Proprietary Trading and Certain Relationships
with Hedge Funds and Private Equity Funds*

Section 13 would prohibit certain financial firms from engaging in proprietary trading or entering into certain relationships with hedge funds and private equity funds. In particular, appropriate federal banking agencies would be empowered to “jointly prohibit proprietary trading by an insured depository institution or by a company that controls an insured depository institution or is treated as a bank holding company for purposes of this Act.”²³ These same banking agencies would also be authorized to “jointly prohibit sponsoring and investing in hedge funds and private equity funds by an insured depository institution or by a company that controls an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act.”²⁴ The term *proprietary trading*, as defined by the Volcker Rule, means

purchasing or selling, or otherwise acquiring and disposing of, stocks, bond, options, commodities, derivatives, or other financial instruments for the institution’s or company’s own trading book, and not on behalf of a customer, as part of market making activities, or otherwise in connection with or in facilitation of customer relationships, including hedging activities related to the foregoing.²⁵

Finally, no insured depository institution—or company that controls an insured depository institution—or bank holding company that “serves, directly or indirectly, as the investment manager or investment adviser” to hedge funds or private equity funds may enter into a covered transaction, as defined in section 23A of the Federal Reserve Act,²⁶ with

23. *Volcker Rule*, *supra* note 4, § 13(a). The term *bank holding company* means “any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter.” 12 U.S.C. § 1841(a)(1).

24. *Volcker Rule*, *supra* note 4, § 13(b).

‘Sponsoring’ a fund means—

- (A) serving as a general partner, managing member, or trustee of a fund;
- (B) in any manner selecting or controlling (or having employees, officers, or directors, or agents who constitute) a majority of the directors, trustees or management of a fund; or
- (C) sharing with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

Id. § 13(f)(3)(A)–(C).

25. *Volcker Rule*, *supra* note 4, § 13(f)(1).

26. *Id.* § 13(b)(2). The term *covered transaction* is generally defined as (1) an extension of credit to an affiliate, (2) a purchase of, or an investment in, a security issued by

such funds or “provide custody, securities lending, and other prime brokerage services to” such funds.²⁷

Importantly, the Volcker Rule leaves open the possibility that similar regulations will apply to certain nonbank financial entities in stipulating that the Federal Reserve Board may adopt further “rules imposing additional capital requirements and specifying additional quantitative limits for nonbank financial companies under its supervision that engage in proprietary trading and sponsoring and investing in hedge funds and private equity funds.”²⁸ As will become more transparent in the analysis to follow, we view the possibility of similar regulatory intrusions upon the proprietary trading activities of nonbank financial companies, as suggested by what appears to be a sort of catchall provision, with a certain measure of suspicion and opposition.

2. Concentration Limits on Large Financial Firms

Finally, the Volcker Rule would further amend the Bank Holding Company Act by adding new section 13a, which imposes concentration limits on large financial firms.²⁹ In particular, a financial company³⁰ would no longer be free to “merge or consolidate with, acquire all or substantially all of the assets of, or otherwise acquire control of, another company if the acquiring financial company’s total consolidated liabilities upon consummation of the transaction would exceed 10% of the aggregate consolidated liabilities of all financial companies.”³¹

In offering a critique of the various policy proposals summarized above and setting forth an alternative framework that we humbly suggest better addresses several of the underlying issues motivating these proposed statutory amendments, the present Article proceeds as follows: Part II constructs a simple conceptual framework. Difficult-to-price

an affiliate, (3) a purchase of an asset from an affiliate, (4) the acceptance of a security issued by an affiliate as collateral for an extension of credit to any person or company, and (5) the issuance of a guarantee, acceptance or letter of credit on behalf of the affiliate. See 12 U.S.C. § 371c(b)(7)(A)–(E) (2006).

27. *Volcker Rule*, *supra* note 4, § 13(b)(2)(A).

28. *Id.* § 13(e)(1).

29. *Id.* § 13a.

30. “‘Financial company’ means any insured depository institution, any bank holding company, any other company that controls an insured depository institution, any nonbank financial company supervised by the Board, and any foreign bank or company treated as a bank holding company for purposes of this Act.” *Id.* § 13a(c)(1).

31. *Id.* § 13a(a). “‘Liabilities’ equals a financial company’s total risk-weighted assets, as determined pursuant to the risk-based capital rules applicable to bank holding companies, as adjusted to reflect exposures that are deducted from regulatory capital, less the company’s total regulatory capital under the risk-based capital rules applicable to bank holding companies.” *Id.* § 13a(c)(2). “For a foreign-based financial company, ‘liabilities’ equals only the total risk-weighted assets of its U.S. operations.” *Id.* § 13a(c)(2).

securities and the relevant financial players are defined. Two behavioral effects are then highlighted as most important with respect to securities trading. In Part III, we argue that the Private Securities Litigation Reform Act (PSLRA) safe harbor should not apply to investment banks issuing difficult-to-price securities. We also advocate for the return of the private investment banking partnership as the most sensible way in which to get the relevant behavioral incentives right vis-à-vis the bank and its clients, and we propose two regulatory measures designed to induce such banks to structure themselves as private partnerships in a world where they would otherwise be free to publicly incorporate. Finally, Part IV sets forth what we think should be the relevant duties owed to investors by investment advisers and broker-dealers, respectively, and it argues, in addition, that the Volcker Rule's push to proscribe proprietary trading is misplaced insofar as it might apply specifically to broker-dealers and investment advisers.

II. A SIMPLE CONCEPTUAL FRAMEWORK

A simple conceptual framework is first set forth, which involves (1) defining what we mean by a difficult-to-price security, as well as introducing the relevant financial players, and (2) highlighting two important behavioral or psychological effects that we believe ought to guide rulemaking in the context of securities trading.

A. Constituent Elements

Part II.A.1–2 introduces (1) the distinction between easy-to-price and difficult-to-price securities and (2) the relevant financial players.

1. Two Categories of Financial Instruments

Suppose that the set of marketable financial instruments can be divided conceptually into two distinct categories: (1) easy to price and (2) difficult to price.³² Whether a security can be classified as one or the other is assumed to depend upon three factors³³: (1) its own market

32. In practice, of course, this variable will be continuous, with most securities falling somewhere along an ease-of-pricing continuum. For ease of exposition, however, we confine the discussion to the discrete case.

33. Note that these categories generally correspond to the three types of valuation techniques commonly used by market participants: (1) mark-to-market, (2) mark-to-matrix,

liquidity—defined as the probability that the next trade in the relevant market is executed at a price equal to the last, (2) the liquidity of markets for similar asset classes, and (3) the ease with which mandated disclosures are mapped onto the security’s true risk-return profile.³⁴

To amplify this definition, we consider a few examples. The issuance of common stock by a well-known, seasoned issuer in a well-established industry would be easy to price under this definition.³⁵ The stock of such companies tends to trade in well-organized markets, with large volumes of transactions executed each and every day. Many of the “risk factors” confronted by a particular company are shared by other corporations competing in the same industry, corporations whose stocks also trade in similarly well-organized, highly liquid markets. The various theoretical models that have been employed to “price” stocks are comparatively straightforward and routinely rely on readily available, publicly disclosed salient information.³⁶ The mathematical techniques

and (3) mark-to-model. See Manmohan Singh & Mustafa Saiyid, *Credit Market Turmoil Makes Securities Valuation Key*, IMF SURV. MAG., Feb. 2008, at 24. As explained by Manmohan Singh and Mustafa Saiyid:

Mark-to-market refers to the use of quoted prices for actively traded, identical assets. Mark-to-matrix is a technique used for less actively traded assets, such as emerging market securities, municipal bonds, and asset-backed securities (ABS). It involves estimating [a credit spread] of the asset by relating it to a more actively traded instrument that can be priced easily.

The third method of pricing is the mark-to-model technique that market participants are often forced to use for the least liquid assets, including real estate, private equity investments, and complex structured securities such as certain tranches of collateralized debt obligations (CDOs). Mark-to-model assigns prices based on statistical inference.

Id.

34. In what follows, the term *risk* refers to circumstances where the decisionmaker can assign mathematical probabilities to perceived randomness; by contrast, the term *uncertainty* refers to circumstances where this randomness cannot be expressed in terms of exact mathematical probabilities. See FRANK H. KNIGHT, *RISK, UNCERTAINTY AND PROFIT* 20 (1921). See generally JACK HIRSHLEIFER & JOHN G. RILEY, *THE ANALYTICS OF UNCERTAINTY AND INFORMATION* (1992); JEAN-JACQUES LAFFONT, *THE ECONOMICS OF UNCERTAINTY AND INFORMATION* (1989).

35. Stocks are defined more by uncertainty than risk. As opposed to risk, there are few models that attempt to model uncertainty or, alternatively, that do so well. Stocks are therefore defined as easy to price not only because of the existence of liquid, well-functioning equity markets but also because the extent to which the true price depends on uncertainty as opposed to risk makes the pricing exercise so difficult as to render good theoretical models virtually nonexistent. In that sense, it may be that easy-to-price securities are better classified as impossible-to-price securities. We have chosen the term *easy* as opposed to *impossible*, however, to capture the fact that in practice, little, if any, effort need be exerted to price this type of security.

36. Most stock valuation methods involve discounting the profits—dividends, earnings, or cash flows—that the stock will yield in the foreseeable future, as well as upon disposition. The discounted rate typically includes a risk premium that is based on the capital asset pricing model (CAPM). Similarly, fundamental valuation models also exist that attempt to forecast returns from a company’s expected future financial performance

applied to price these stocks on the basis of this publicly disclosed information are generally familiar to, and understood by, most competent hedge fund and private equity managers, investment advisers, and other such investment professionals.

Corporate bonds present a more difficult case. Corporate bonds are “inherently illiquid and, except for shortly after issuance,” tend to trade infrequently.³⁷ Moreover, there is not always another issuance to which this particular debt can be readily compared. In addition, there are now underlying risks—as opposed to uncertainties—that tend to complicate the pricing exercise; in particular, the price of a corporate bond depends not only on general interest rate risk but also on the specific credit risk of the issuing company—and if the bond is convertible into stock, on its equity risk as well. Therefore, as compared with stock valuation models, greater technical expertise is required to incorporate, in some meaningful way, these known risks into a coherent and competent pricing model. Further, because the regulatory disclosures required of most U.S. issuers arguably are insufficient to provide investors with a full and comprehensive picture of a company’s total risk exposures, greater logistical effort might also be needed in the form of independent research and data collection.³⁸ The typical investment professional is not necessarily

and differ from CAPM-type models that conceive of expected return as the sum of a risk-free rate plus a premium for exposure to return variability. The Estep T-Model, for example, specifies returns earned by holders of a company stock in terms of accounting variables readily obtainable from the company’s financial statements. See, e.g., Preston W. Estep, *A New Method for Valuing Common Stocks*, FIN. ANALYSTS J., Nov.–Dec. 1985, at 26, 26–27; Preston W. Estep, *Cash Flows, Asset Values, and Investment Returns*, 29 J. PORTFOLIO MGMT. 17, 18 (2003). But see Hubert J. Dwyer & Richard Lynn, *Is the Estep T-Model Consistently Useful?*, FIN. ANALYSTS J., Nov.–Dec. 1992, at 82, 82.

37. See Michael Decker, FINRA’s TRACE and the U.S. Corporate Bond Market 2 (Sept. 11, 2007) (unpublished presentation) (on file with Securities Industry and Financial Markets Association).

38. In July 2002, the National Association of Securities Dealers introduced the Trade Reporting and Compliance Engine (TRACE) “in an effort to increase price transparency in the U.S. corporate debt market. The system captures and disseminates consolidated information on secondary market transactions in publicly traded TRACE-eligible securities (investment grade, high yield and convertible corporate debt)—representing all over-the-counter market activity in these bonds.” *TRACE Corporate Bond Data*, FINRA, <http://www.finra.org/Industry/Compliance/MarketTransparency/TRACE/CorporateBondData> (last visited Aug. 23, 2011). Its efficacy is hotly debated, however. See, e.g., Hendrik Bessembinder et al., *Market Transparency, Liquidity Externalities, and Institutional Trading Costs in Corporate Bonds*, 82 J. FIN. ECON. 251, 283 (2006) (finding dealer markups have decreased following the introduction of TRACE); Amy K. Edwards et al., *Corporate Bond Market Transaction Costs and Transparency*, 62 J. FIN. 1421, 1422 (2007) (same). But see Robert Bloomfield & Maureen O’Hara, *Market Transparency: Who Wins and*

endowed with all of the technical skills required to successfully implement this type of analysis on a large scale.

Lastly, qualifying as difficult to price under our definition, consider certain types of structured products, such as a credit-default obligation (CDO) comprised exclusively of mortgage-backed securities (MBS). Very often MBS will be “inherently illiquid at the time of issuance . . . because each debt tranche had different levels of credit enhancement and the composition (and quality) of the underlying collateral” varies from one deal to the next.³⁹ Moreover, the illiquidity of these complex-structured securities is often compounded or exacerbated by a lack of transparency as to the exposure to underlying nonprime mortgage loans.⁴⁰ And as for valuation, although pricing an MBS might appear a relatively straightforward exercise—a fixed-rate mortgage offering fixed, nominal payments that are known and disclosed, suggesting that fixed-rate MBS prices ought to be governed by pure discount bond prices—the complexity arises from the fact that residential mortgagees in the United States have the option to pay more than the required monthly payment (curtailment) or, alternatively, to pay off the loan in its entirety (prepayment); hence, “MBS investors are implicitly writing a call option on a corresponding fixed-rate bond.”⁴¹

In particular, the number of homeowners who repay as such tends to increase when interest rates decrease because, for instance, homeowners can now refinance their mortgages at a lower fixed interest rate. The speed at which mortgages are prepaid is also impacted by other non-interest-related variables as well, such as homeowner mobility and inertia. Because the links between prepayment risk and these other related factors are difficult to quantify, the timing and cash flow from an MBS are both risky and uncertain,⁴² which makes the task of calculating a theoretical price for the CDO—with the cash flows from various MBS allocated to various tranches of the CDO according to complicated, deal-

Who Loses?, 12 REV. FIN. STUD. 5, 8, 18–20 (1999) (arguing that market liquidity—as measured by the inverse of the width of the bid-ask spread—may decrease with increased transparency in a market).

39. See Singh & Saiyid, *supra* note 33, at 24.

40. *Id.*

41. Jacob Boudoukh et al., *Pricing Mortgage-Backed Securities in a Multifactor Interest Rate Environment: A Multivariate Density Estimation Approach*, 10 REV. FIN. STUD. 405, 406 (1997); see also Efraim Benmelech & Jennifer Dlugosz, *The Alchemy of CDO Credit Ratings*, 56 J. MONETARY ECON. 617, 621 (2009). See generally Chris Downing et al., *Is the Market for Mortgage-Backed Securities a Market for Lemons?*, 22 REV. FIN. STUD. 2457, 2458 (2009).

42. Further complicating matters, prepayments are also likely to be a function of economic growth, which is, in turn, correlated with turnover in the housing market, inflation, unemployment, regulatory risk, and demographic trends, including shifting individual-risk profiles.

specific rules—a very difficult problem in mathematical finance; indeed, it is one that has, up to this point, continued to elude a closed-form solution.⁴³

2. *The Financial Players*

The relevant financial players in this conceptual framework are now introduced. An investment bank issues/underwrites financial instruments. The investment bank sells these instruments—perhaps via a broker-dealer—to investment advisers in the primary market. Investment advisers decide how to invest the hard-earned money of lay investors, purchasing from investment banks in the primary market and broker-dealers in the secondary market a variety of different financial instruments—including those that are difficult to price. Rather than invest indirectly with the investment adviser, investors may also choose to deal directly with broker-dealers in purchasing financial instruments in the secondary market. The broker-dealer is conceptualized as implementing a Walrasian tâtonnement mechanism.⁴⁴

Note that the modern “investment bank” can often comprise all three financial players; within the same financial institution, a security can be issued by an investment banker, marketed by its sales division, and sold by one of its own broker-dealers to a client, whose assets are managed by an investment adviser employed by the very same bank. To preview what is to come, the Article suggests that this bundling of different players within a single institutional entity, this blurring of the lines, leads to important and entirely unacceptable conflicts of interest that ought to be eliminated via the sorts of sharp line-drawing exercises prescribed by

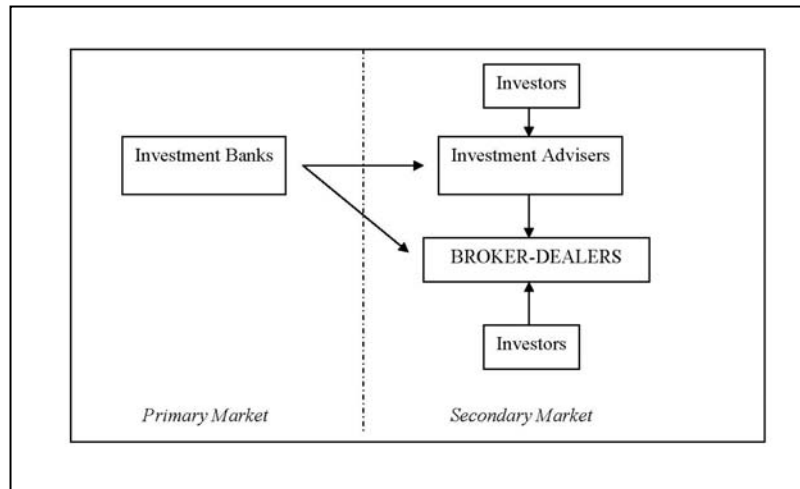
43. See, e.g., Boudoukh et al., *supra* note 41, at 409–19; Singh & Saiyid, *supra* note 33, at 24.

44. See generally Patrick Joyce, *The Walrasian Tâtonnement Mechanism and Information*, 15 RAND J. ECON. 416 (1984) (conducting experiments that show that such auction mechanisms are stable, exhibiting strong convergence properties and efficiency levels averaging better than 97%). To the extent that securities markets should be made to conform to the conditions of this experiment, the experimental tâtonnement mechanism possessed the following characteristics: “[T]here [was] only one price at any time; there [was] an information mechanism notifying all traders of that price; there [was] a mechanism for determining quantities offered for sale and purchase at the price; and transactions at nonequilibrating prices [were] forbidden.” *Id.* at 416–17. Additionally, the Walrasian pricing rule was used by the “auctioneer”—“the change in price [had] the same sign as excess demand.” *Id.* at 416.

the original Glass-Steagall Act of 1933,⁴⁵ although the lines advocated here are not necessarily the same, nor are they motivated by precisely the same underlying considerations and concerns.

The preceding discussion is summarized visually in Figure 1.

FIGURE 1
THE FINANCIAL PLAYERS



B. Two Important Behavioral Effects

A host of different terms and frameworks in psychology and behavioral finance are available to describe the various effects at work in securities trading, including, inter alia, size effects,⁴⁶ overconfidence effects,⁴⁷ and disposition effects.⁴⁸ Rather than glibly state that such behavioral phenomena exist or, alternatively, attempt to amass some definitive, all-encompassing catalogue of all such effects, it is valuable, we think, to make a positive assumption as to which few are likely to be most important. To that end, the two effects that we believe ought to

45. Banking Act of 1933 (Glass-Steagall Act), Pub. L. No. 73-66, 48 Stat. 162 (codified in scattered sections of 12 U.S.C.).

46. See, e.g., Jonathan B. Berk, *A Critique of Size-Related Anomalies*, 8 REV. FIN. STUD. 275, 276 (1995).

47. See, e.g., Brad M. Barber & Terrance Odean, *Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment*, 116 Q.J. ECON. 261, 289 (2001).

48. See, e.g., Martin Weber & Colin F. Camerer, *The Disposition Effect in Securities Trading: An Experimental Analysis*, 33 J. ECON. BEHAV. & ORG. 167, 167-68 (1998).

loom largest when rulemaking with respect to securities trading are (1) the house money effect and (2) the earned money effect.

1. *The House Money Effect*

The house money effect is an example of a mental accounting in which agents mentally keep quantities of money in artificially separate accounts.⁴⁹ Agents who exhibit the house money effect consider house money gains as distinct from the rest of their wealth and therefore are more likely to gamble these gains than would be the case otherwise. The house money effect is consistent with prospect theory; specifically, suppose that the investor invests \$100,000 in an investment where, with probability p , the investment doubles, and with probability $(1 - p)$, the investment is worth zero where $0 \leq p \leq 1$. In addition, assume that an investment professional keeps a proportion of the profits, σ , where $0 \leq \sigma \leq 1$.

The payoffs for the investor, P_I , and investment professional, P_{IP} , respectively, can be represented as follows⁵⁰:

$$P_I = p100(1 - \sigma) + (1 - p)(-100) = 100[(2 - \sigma)p - 1]$$

and

$$P_{IP} = p100\sigma + (1 - p)(0) = 100\sigma p$$

Observe that no matter what the expected rate of return on the investment is—for all feasible values of p —the investment is profitable for the investment professional, provided, of course, that the professional receives a nonzero proportion of profits—or equivalently, $100\sigma p > 0$ for all $p > 0$ and $\sigma > 0$. This is true because the investment professional views the investor's money as house money. It is distinct as compared with the investment professional's own personal wealth, and therefore it is kept in a separate account. Accordingly, the investor's losses are not

49. See Richard H. Thaler & Eric J. Johnson, *Gambling with the House Money and Trying To Break Even: The Effects of Prior Outcomes on Risky Choice*, 36 J. INST. MGMT. SCI. 643, 657 (1990). See generally Lucy F. Ackert et al., *An Experimental Examination of the House Money Effect in a Multi-Period Setting*, 9 EXPERIMENTAL ECON. 5 (2006) (discussing the house money effect in a financial setting).

50. Payoffs correspond to the risk neutral von Neumann-Morgenstern utility representation for preferences over discrete lotteries. See Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 280 (1979).

the investment professional's losses.⁵¹ Furthermore, note that the investment is profitable for the investor if and only if $(2 - \sigma)p - 1 > 0$, or equivalently, if and only if $p > 1/(2 - \sigma)$. The investment must have a better-than-even chance of doubling in value for it to be profitable for the investor; that is, the probability p must at least satisfy $p > 1/2$. Similarly, the greater the investment professional's take, σ , the fewer the investments that the investor will find attractive; indeed, where $\sigma = 1$, the investor finds no investments profitable, which makes sense.

The purpose of this stylized example is simply to highlight the extent to which preferences over the same investment may differ between the investor and the investment professional for reasons having nothing to do with preferences over risk as traditionally defined.⁵² Rather, the difference in preferences stems from how these two individuals "perceive" their respective baseline levels of wealth. For the investor, that baseline is \$100,000; for the investment professional, by contrast, it is \$0. Excessive risk-taking behavior, defined as gambling on investments that the investor would not otherwise find profitable, is therefore more likely to be observed the greater the extent to which the money with which the investment professional is entrusted represents, in the professional's own mind, not his or her own money but someone else's.

2. *The Earned Money Effect*

Pushing further the underlying theme of the preceding discussion, how an individual feels about a certain sum of money will likely depend not only on whether that sum represents one's own money or house money but also on the level of personal effort that has been exerted in the past to acquire that sum. In other words, all else equal, the "value" that an individual places on, say, \$100,000 will vary depending on whether, for example, the individual has spent several years working hard to earn that sum or, alternatively, received that sum as the proceeds of a winning lottery ticket. It seems quite plausible that one will value the hard-fought dollar more than the dollar that comes easy, holding dearer the dollar that is the product of blood, sweat, and tears than the dollar that was obtained without ever lifting a finger. Indeed, this behavioral effect can be properly conceptualized as a variant of the "endowment effect"—the hypothesis that people will value a good more once a property right

51. Formally, this corresponds to the fact that where the investment is worth zero, the investment professional's losses are equal to zero, and the investor's losses equal to -100.

52. For a more detailed treatment of preferences over risk and uncertainty, see generally ITZHAK GILBOA, *THEORY OF DECISION UNDER UNCERTAINTY* (2009).

to it has been established⁵³—or alternatively, as a variant of the “sunk cost effect”—manifested where there exists a greater tendency to continue an endeavor once an investment in effort has been made.⁵⁴

In the context of the foregoing investment opportunity, if we assume that the investment professional is forced to take a loss equal in value to the investor’s, then the financial reality of the transaction with respect to the investor and the investment professional appears equivalent. But of course, this is not entirely true. Putting to the side considerations of diminishing marginal utility of wealth,⁵⁵ psychologically the \$100,000 loss will surely weigh more heavily on the individual for whom this represents ten years of savings than on the individual for whom this represents yesterday’s trading gains—the thought of all those years of hard work lost, all that effort expended only to be squandered so, causing the investor to “value” the magnitude of the loss more than will the investment professional for whom that sum might represent trading gains earned over the past several days or, perhaps, even hours or minutes.⁵⁶

This so-called earned money effect can be formally represented by writing the investment professional’s preferences with respect to the investment opportunity as follows:

$$P_{IP} = ph(100) - (1 - p)100 = (h(100) + 100)p - 100$$

As long as the function $h(\cdot)$ is strictly convex—and thus, $h(100) > 100$ —preferences over investments are once again misaligned. Investment professionals will find certain investments attractive that investors would

53. See, e.g., Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1338–39 (1990) (finding randomly assigned owners of a mug required significantly more money to part with the mug—around \$7—than randomly assigned buyers were willing to pay to acquire it—around \$3).

54. Interestingly, in their original pioneering work, Kahneman and Tversky suggested that sunk costs have the opposite effect, inducing a “loss frame” that, in turn, leads to risk-seeking behavior. See Kahneman & Tversky, *supra* note 50, at 268–69. It has been shown, however, that sunk costs also result in risk aversion. See generally Marcel Zeelenberg & Eric van Dijk, *A Reverse Sunk Cost Effect in Risky Decision Making: Sometimes We Have Too Much Invested To Gamble*, 18 J. ECON. PSYCHOL. 677 (1997) (showing that incurring “behavioral sunk costs” appears to increase risk-averse choices—what they call a “reverse sunk cost effect”).

55. Marginal utility of wealth effects can be controlled for by increasing the loss incurred by the investment professional. Akin to the endowment effect, the claim is that these wealth effects alone, however, will not fully explain the observed differences in valuation. See Kahneman et al., *supra* note 53, at 1342.

56. See Zeelenberg & van Dijk, *supra* note 54, at 678–80.

not—again, for reasons having nothing to do with differing marginal utilities of wealth or preferences over risk but rather because what is at stake for the investment professional simply does not have the same intrinsic psychological value as it does for the investor.

In order to cure these misalignments stemming from the house money effect and the earned money effect, the investment professional must be made to suffer a “real loss.” Specifically, the approach is to require that the professional put some of his or her own money into the mix; if the investor has invested $\$X \geq 0$, then the investment professional must be made to similarly invest $\$Y \geq 0$ of his or her own money. Interpreting the parameters as above, the investment professional’s preferences over investment opportunities can thus be written as follows:

$$P_{IP} = pY + (1 - p)(-Y) + p\sigma h(X)$$

Rearranging terms, the investment professional now finds the investment profitable if and only if:

$$p > \frac{1}{2} > Y / (2Y + h(X)\sigma)$$

Observe that the larger Y is with respect to $h(X)$ and σ , the greater the extent to which the investment professional’s preferences correspond to the investor’s preferences, where we should recall that the investor finds the investment attractive only if $p > \frac{1}{2}$.⁵⁷ Similarly, note that the smaller the proportion of profits retained by the investment professional (σ small) and the more the investment professional treats the investor’s money as hard earned (the less convex the function $h(\cdot)$), the greater the extent to which preferences match; indeed, where $\sigma = h(X) = 0$, preferences match exactly.

a. The Earned Money Effect as It Impacts Research Effort

Now suppose that the investment professional can exert research effort $e \geq 0$ at unit cost to determine the true outcome of the investment: Y or $-Y$, where the decision to exert costly effort must be made *before* the true outcome of the investment is revealed. If the outcome is $-Y$, then the investment professional will, of course, not proceed with this particular investment. On the other hand, if the outcome is Y , then with effort e , now sunk, the investment professional might as well pocket Y , and so the expected payoff of research effort therefore is $pY - e$. Hence, the investment professional will exert e if and only if:

$$pY - (1 - p)Y < pY - e$$

57. See *supra* Part II.B.1.

or equivalently, if and only if:

$$(1 - p)Y > e$$

Assume that the earned money effect characterizes the securities trading environment. Interpreting the function $h(\cdot)$ exactly the same as above, it is easy to show that the trader now chooses to exert e if and only if:

$$pY - (1 - p)h(Y) < pY - e$$

or equivalently, if and only if⁵⁸:

$$(1 - p)h(Y) > e$$

Because the left-hand side of this second equation is smaller than the left-hand side of the first equation, which was derived where behavioral effects were assumed absent—because $h(Y) < Y$ —the set of investment opportunities (p, Y) , where the investment professional chooses not to invest in research effort in order to determine the true nature of the investment opportunities, has *increased*. This is true because the losses are not deemed as great, and so the investment professional is less willing to pay to avoid them than would otherwise be true were such behavioral effects not present.

As will be emphasized repeatedly in what follows, we believe that this research effort should be encouraged and incentivized wherever possible. This simple analysis demonstrates why. Although it is admittedly an empirical question in each particular instance, depending on research costs and the probability and magnitude of the investment opportunities at issue, the general thrust of the preceding discussion is hopefully clear—that behavioral effects exist that discourage profitable investment

58. This problem is magnified with the presence of optimistic traders. See, e.g., Oren Bar-Gill, *The Evolution and Persistence of Optimism in Litigation*, 22 J.L. ECON. & ORG. 490, 490–91 (2006); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 806, 813–14 (1980). Formally, suppose traders' *subjective* probability that the investment doubles is $s(p)$, where, importantly, $s(p) > p$. It can be shown that the trader now spends e if and only if:

$$s(p)Y - (1 - s(p))h(Y) < pY - e$$

or equivalently, if and only if:

$$(1 - s(p))h(Y) > e + (s(p) - p)Y$$

Comparing this inequality with the expression derived above, because the left side of the equation is even smaller and the right side even larger, it follows that the set of investment opportunities in which the traders choose not to exert effort has further increased.

research. These effects can be mitigated, or eliminated altogether, by opening up investment professionals to the possibility of incurring “real losses” \$Y. How we might go about actually doing this in practice is taken up in Part III.

III. INVESTMENT BANKS

This Part sets for itself three distinct objectives: (1) to argue that the PSLRA safe harbor should not apply to investment banks that issue/underwrite difficult-to-price securities, (2) to advocate for the return of investment banking partnerships as the most sensible way in which to get the incentives right vis-à-vis the investment bank and its clients, and (3) to propose two regulatory measures designed to induce investment banks to structure themselves as private partnerships in a world where such banks are otherwise free to publicly incorporate.

A. Eliminate PSLRA Safe Harbor Protection for Difficult-to-Price Securities

The core of the safe harbor provision is the section that sets forth the circumstances under which a forward-looking statement is immune from civil legal liability.⁵⁹ In particular, in a private civil action brought on the basis of an untrue statement of material fact or an omission of a material fact, an issuer will not be held liable with respect to a forward-looking statement—whether written or oral⁶⁰—if it meets any one of three alternative tests: (1) it is accompanied by meaningful cautionary language,⁶¹ (2) it is immaterial,⁶² or (3) the defendant lacked the requisite state of mind to commit fraud.⁶³

59. See 15 U.S.C. § 77z-2 (2006). The safe harbor provisions are applicable only with respect to private civil litigation and do not apply where enforcement actions are brought by the SEC or where criminal prosecutions are brought by the Department of Justice. See 15 U.S.C. § 78u-5(c)(1) (2006).

60. See 15 U.S.C. §§ 77z-2(c)(1), 78u-5(c)(1).

61. A mere boilerplate is insufficient. See, e.g., *In re Computer Assocs. Sec. Litig.*, 75 F. Supp. 2d 68, 73 (E.D.N.Y. 1999) (finding cautionary statements “there can be no assurances that future results will be achieved” and “[there are] important factors that could cause actual results to differ materially” to be general boilerplate disclaimers and therefore insufficient to bring the statements within the safe harbor); *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160, 1168 (W.D. Wash. 1998) (holding that where the company had predicted a “near-term decline in productivity,” its statements describing the cause of the company’s then-current production problems did nothing to “warn[] investors of factors that could cause a steeper decline in the company’s productivity or an extension of that period of inefficiency”); see also 141 Cong. Rec. H13703 (daily ed. Nov. 28, 1995) (statement of Hon. Bob Barr) (“[C]autionary statements must convey substantive information about factors that realistically could cause results to differ . . . such as . . . information about the issuer’s business.”); cf. *Harris v. IVAX Corp.*, 998 F. Supp. 1449,

Part III.A.1–3 provides three distinct critiques of the PSLRA safe harbor as applied to an investment bank that issues/underwrites difficult-to-price financial instruments: (1) an economic critique, (2) a legal critique, and (3) a behavioral critique.

1454 (S.D. Fla. 1998) (deeming such factors as “increased competition and the purchasing decisions of existing customers, the volatile nature of the generic drug industry itself and the unpredictability of the degree and timing of price competition, the speed of the restructuring of the [company’s] production facilities, mistaken estimates and assumptions concerning customer inventory shelf stock adjustments, [and] other information identified in [the company’s] SEC filing” not impermissible boilerplate), *aff’d*, 182 F.3d 799 (11th Cir. 1999). Moreover, it is clear from the legislative history that to be protected, an issuer need not have included *all* factors that might have materially affected the predictive disclosures; indeed, as the Conference Report states, “[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor.” H.R. REP. NO. 104-369, at 44 (1995), *reprinted in* 1995 U.S.C.A.N. 730, 743; *see also Harris*, 182 F.3d at 807 (“[W]hen an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward.”). Similarly, the doctrine does not apply to statements of current or historical fact. *See In re Westinghouse Sec. Litig.*, 90 F.3d 696, 708–10 (3d Cir. 1996) (reversing in part district court’s dismissal of complaint because it could not find as a matter of law that defendants’ representations were projections and not misrepresentations of historical fact); *In re Valujet, Inc., Sec. Litig.*, 984 F. Supp. 1472, 1479 (N.D. Ga. 1997) (concluding that because plaintiffs did not allege that defendants “fraudulently announced expansion plans and then failed to follow through on these plans” but rather alleged “misrepresentation of existing facts,” specifically that “FAA approval was required before expansion could be consummated,” statements and omissions were therefore not “forward-looking”).

62. Courts’ preferred approach for dismissing claims arguing for safe harbor protection seems to be to view the challenged statements as nothing but “puffery” and therefore immaterial. *See, e.g., San Leandro Emergency Med. Grp. Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 811 (2d Cir. 1996) (declaring statements that issuer was “‘optimistic’ about its earnings” and “‘expected’ [good sales]” to be “puffery” and therefore immaterial); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 283 n.12 (3d Cir. 1992) (finding statement “United Jersey looks to the future with great optimism” to be “inactionable puffing” (internal quotation marks omitted)); *see also In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1427–28 (3d Cir. 1997) (finding vague and therefore immaterial a “general, nonspecific statement of optimism or hope that a trend will continue”). Courts have also found specific forward-looking statements to be immaterial as a matter of law—and thus not actionable—where the statement is meaningless. *See, e.g., Karacand v. Edwards*, 53 F. Supp. 2d 1236, 1252 (D. Utah 1999) (holding that “surprises” are, by definition, unexpected and that the statement “‘we don’t expect any [surprises] in the [upcoming] quarter’ is therefore meaningless and immaterial”).

63. This standard—actual knowledge of falsity—is more demanding than is traditional under SEC Rule 10b-5, which courts have interpreted as creating private liability for statements that are merely reckless. *See, e.g., Richard A. Rosen, The Statutory Safe Harbor for Forward-Looking Statements After Two and a Half Years: Has It Changed the Law? Has It Achieved What Congress Intended?*, 76 WASH. U. L.Q. 645, 661 (1998).

1. The Economic Critique

In terms of the *quantity* of voluntary disclosure, the safe harbor provision, in restricting investors' capacity to sue where projections are not met—thus decreasing the legal costs of such disclosure—should make managers more willing to issue a greater number of good-news forecasts.⁶⁴ Likewise, the expected legal costs associated with failing to achieve management forecasts may also influence the form in which forward-looking information is communicated to the market. Managers are hesitant to announce forecasts that have a high probability of proving to be incorrect *ex post*. Because the safe harbor provision insulates issuers from legal liability where projections are not met, this provision should therefore serve to increase disclosure of long-horizon forecasts, as well as those forecasts that provide more specific or detailed estimates of anticipated results.

In terms of the *quality* of voluntary disclosure, however, recognize that prospective disclosures are useful only to the extent that the information disclosed is (1) credible—free of intentional bias or misrepresentation—and (2) precise—free of extraneous noise. It is not hard to imagine a scenario where managers perceive safe harbor protection as a “license to lie” and as a consequence are thus *overly optimistic* in their statements to investors, especially, as will be discussed in greater detail below, where it is unlikely that investors understand the full import of the disclosures being made in the first place.⁶⁵ In other words, because the litigation environment imposes an asymmetric loss function on issuers insofar as an issuer is more likely to

64. Scholars have shown that managers are more likely to preempt large negative earnings surprises than other types of earnings news. See Douglas J. Skinner, *Why Firms Voluntarily Disclose Bad News*, 32 J. ACCT. RES. 38, 39–40 (1994) (arguing that managers have an incentive to voluntarily disclose bad news that prepare investors for a disappointing earnings announcement). Because the Act reduces the marginal benefit of voluntarily disclosing bad news, the argument is that managers will issue fewer bad-news forecasts. See Douglas J. Skinner, *Do the SEC's Safe Harbor Provisions Encourage Forward-Looking Disclosures?*, FIN. ANALYSTS J., July–Aug. 1995, at 38, 38, 41, 43; see also Ron Kasznik & Baruch Lev, *To Warn or Not To Warn: Management Disclosures in the Face of an Earnings Surprise*, 70 ACCT. REV. 113, 114–15, 133 (1995). On the other hand, other authors suggest that the voluntary disclosure of bad news may be a contributing factor in securities litigation. See Jennifer Francis et al., *Shareholder Litigation and Corporate Disclosures*, 32 J. ACCT. RES. 137, 137 (1994); Douglas J. Skinner, *Earnings Disclosures and Stockholder Lawsuits*, 23 J. ACCT. & ECON. 249, 253–54 (1997). From this perspective, managers will therefore be more likely to issue bad-news forecasts after the passage of the Act because the marginal cost of these announcements is reduced.

65. See David Carey, *Liar's License: Securities Litigation 'Reform' Will Make It Easier To Cheat Investors*, FIN. WORLD, Feb. 26, 1996, at 92, 92–93; see also Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience* (Stanford Law Sch., Working Paper No. 97-1, 1997), available at http://securities.stanford.edu/research/studies/19970227firstyr_firstyr.html.

be sued if there is a large negative return at its earning announcement, this loss function may thereby encourage firms to forecast less optimistically than would be true were there no such incentive to avoid litigation.⁶⁶ Moreover, the mere threat of disclosure-related litigation may have the effect of causing managers to abstain from issuing forecasts where it is relatively difficult to predict or anticipate future performance. If litigation concerns are lessened by the existence of a safe harbor, managers may be more inclined to release forecasts where earnings are volatile or, alternatively, are revealed only as a noisy signal. As a result, management forecasts and other such mandated disclosures are likely to be less accurate and less reliable with the availability of a litigation safe harbor.⁶⁷

In short, the economic critique of the PSLRA safe harbor provision thus reduces to the claim that the expected benefits of the increase in the

66. Truthful disclosure of private information is not an equilibrium strategy insofar as such disclosure is properly modeled as “cheap talk.” See Michael Dobler, *Incentives for Risk Reporting—A Discretionary Disclosure and Cheap Talk Approach*, 43 INT’L J. ACCT. 184, 194 (2008). Given imperfect monitoring, credible forecast disclosure can be obtained, however, as a perfect public equilibrium in a repeated game. This multiperiod result requires (1) a manager whose focus is not purely short term, (2) a sufficiently long review phase, and (3) financial statements sufficient to perform the nominal/actual value comparisons. See *id.* at 195. The first two conditions coincide with empirical work verifying substantial misreporting in the presence of short-term speculation or high manager fluctuation. See Charles J. Hadlock & Gerald B. Lumer, *Compensation, Turnover, and Top Management Incentives: Historical Evidence*, 70 J. BUS. 153, 153–55 (1997); Ingmar Nyman, *Stock Market Speculation and Managerial Myopia*, 14 REV. FIN. ECON. 61, 61–62 (2005). The third requires credible disclosure of specific data to conduct a nominal/actual value comparison *ex post*. Whether disclosed financial statements indeed allow for such a comparison is doubtful in our view.

67. There remains a question of whether the market’s response to management forecasts is consistent with its identifying the predictable bias in the forecasts; that is, in an environment where investors hold rational expectations, investors should be expected to filter out the predicted bias when determining stock prices. In an interesting paper, the efficiency of the market’s response is shown to vary with the type of forecast news. See Jonathan L. Rogers & Phillip Stocken, *Credibility of Management Forecasts 2–3* (Rodney L. White Ctr. for Fin. Research, Working Paper No. 07-02, 2003), available at <http://ssrn.com/abstract=401700>. For good-news forecasts, the market’s immediate response is consistent with its viewing these forecasts with skepticism and adjusting for the predicted error. *Id.* at 3. The adjustment seems complete because the authors do not find the subsequent risk-adjusted returns associated with the predicted error. *Id.* For bad-news forecasts, by contrast, the market appears to take them at face value, even though these forecasts are predictably biased. *Id.* Over time, however, the risk-adjusted returns are consistent with the market’s identifying the predicted error and modifying its valuation accordingly. *Id.* Although no doubt a reassuring result, it does raise the question, Why not just get the disclosures right in the first place rather than have to rely on market corrections to fix the defective disclosures on the back end?

quantity of disclosures do not exceed the expected costs of the decrease in the quality of such disclosures. Or to put it more starkly, increased disclosure in the context of firms that issue/underwrite difficult-to-price securities is not to be encouraged if, at the margin, such disclosure merely constitutes overly optimistic forecasts of returns, characterized by significant volatility and made purely, or in large part, on the basis of noisy signals.

2. *The Legal Critique*

Although Congress promulgated the safe harbor as part of a larger effort to thwart vexatious litigation, arguably it succeeded only in unwittingly inviting litigation on other unanticipated grounds⁶⁸—in particular, litigation efforts designed to test the interpretation of the legislation’s ambiguous language.⁶⁹ Because courts often look to the “bespeaks caution” doctrine to clarify the statutory ambiguity, this has had the effect of creating a nonuniform safe harbor between the different circuits because that doctrine has been applied differently in the different circuits,⁷⁰ with the resulting uncertainty in the law thus causing many issuers to remain cautious about making the kinds of forward-looking statements ostensibly worthy of safe harbor protection—or so goes the legal critique.

To amplify this legal uncertainty, many cases, for instance, treat the second prong—actual knowledge—as irrelevant if the first prong is satisfied. At the motion to dismiss or summary judgment stage, many decisions ignore allegations or even proof of actual knowledge that the projection was incorrect if the defendant identified the forward-looking statements as such and accompanied these statements with what the court finds to be meaningful cautionary statements.⁷¹ Basically, these

68. See John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 337 (1996); Margaret A. Jacobs & Edward Felsenthal, *Securities Bill May Prompt New Litigation*, WALL ST. J., Dec. 13, 1995, at B2.

69. The terms *meaningful*, *important*, and *accompany* are prime examples of this oft-criticized ambiguity. See, e.g., Avery, *supra* note 68, at 355–57; see also Carl W. Schneider & Jay A. Dubow, *Forward-Looking Information—Navigating in the Safe Harbor*, 51 BUS. LAW. 1071, 1089–95 (1996).

70. See Allan Horwich, *Cleaning the Murky Safe Harbor for Forward-Looking Statements: An Inquiry into Whether Actual Knowledge of Falsity Precludes the Meaningful Cautionary Statement Defense*, 35 J. CORP. L. 519, 522–23, 526–28 (2010).

71. See, e.g., *Miller v. Champion Enters., Inc.*, 346 F.3d 660, 672 (6th Cir. 2003) (“[I]f the statement qualifies as ‘forward-looking’ and is accompanied by sufficient cautionary language, a defendant’s statement is protected regardless of the actual state of mind.”); see also *In re Stone & Webster, Inc. Sec. Litig.*, 414 F.3d 187, 212 (1st Cir. 2005) (noting that deceitful investors could escape liability upon a showing of a forward-looking statement accompanied by meaningful cautionary statements); Amalgamated

cases rely on an explicit, rigid application of the disjunctive wording of the safe harbor.⁷² Some cases, however, treat the second prong as germane, even if the first prong has been or may be satisfied.⁷³ These cases do not directly address the disjunctive grammatical structure of the statute. Finally, a third perspective—which essentially seeks to meld the two prongs—holds that a finding of undisclosed actual knowledge of falsity means, ipso facto, that the cautionary statements were not meaningful.⁷⁴

*a. Courts that Allow Discovery To Proceed Effectively
Eviscerate the Safe Harbor's Essential Protections*

In addition to the uncertainty created by the unresolved statutory ambiguity, the force of the statutory safe harbor provision has been further diluted by courts that have interpreted the provision so as to have severely weakened—if not eviscerated altogether—its essential protections;

Bank v. Coca-Cola Co., No. Civ.A. 1:05-CV-1226, 2006 WL 2818973, at *4 (N.D. Ga. Sept. 29, 2006) (noting that once a court determines that a statement falls within the safe harbor, the state of mind of the defendant is irrelevant).

72. See *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 371 (5th Cir. 2004) (“The safe harbor has two independent prongs: one focusing on the defendant’s cautionary statements and the other on the defendant’s state of mind.”).

73. See, e.g., *Andropolis v. Red Robin Gourmet Burgers, Inc.*, 505 F. Supp. 2d 662, 676 (D. Colo. 2007) (stating, in dictum, that even a forward-looking statement made with meaningful cautionary statements may be actionable if there are sufficient allegations of actual knowledge of falsity of statement); *Gargiulo v. Isolagen, Inc.*, 527 F. Supp. 2d 384, 389 (E.D. Pa. 2007) (“[T]hough some of the statements are forward-looking and contain cautionary language, they are still not protected by the PLSRA safe harbor because Plaintiffs allege that Defendants had actual knowledge of falsity.”); *Schaffer v. Evolving Sys., Inc.*, 29 F. Supp. 2d 1213, 1224 (D. Colo. 1998) (“Plaintiffs correctly argue that the safe harbor provision provides no refuge for Defendants who make statements with ‘actual knowledge’ of their falsity.”).

74. See, e.g., *In re SeeBeyond Techs. Corp. Sec. Litig.*, 266 F. Supp. 2d 1150, 1165 (C.D. Cal. 2003) (“If the forward-looking statement is made with actual knowledge that it is false or misleading, the accompanying cautionary language can only be meaningful if it either states the belief of the speaker that it is false or misleading or, at the very least, clearly articulates the reasons why it is false or misleading.”); see also *Freeland v. Iridium World Commc’ns, Ltd.*, 545 F. Supp. 2d 59, 74 (D.D.C. 2008) (following *SeeBeyond* in denying summary judgment because of issues of fact regarding defendants’ intent that bore on whether cautionary statements were meaningful); *In re Nash Finch Co. Sec. Litig.*, 502 F. Supp. 2d 861, 873 (D. Minn. 2007) (“This Court concludes that cautionary language can not be ‘meaningful’ when defendants know that the potential risks they have identified have in fact already occurred, and that the positive statements they are making are false.”).

the case *Asher v. Baxter International Inc.* is a prime such example.⁷⁵ The central issue in the case was whether Baxter’s warnings qualified as the “meaningful cautionary statements” required by the safe harbor provision, with plaintiffs contending that the “cautionary statements did not follow the firm’s fortunes.”⁷⁶ Judge Easterbrook expressed deep skepticism as to the workability of the statutory language, commenting that “[t]he fundamental problem is that the statutory requirement of ‘meaningful cautionary statements’ is not itself meaningful.”⁷⁷ He surmised that in a world ideally calibrated to the needs of investors, companies would be required to fully disclose the “assumptions and calculations” behind their projections.⁷⁸ But this is not the world in which we live, of course.

The PSLRA does not require the *most* helpful caution; it is enough [under the statute] to “identify[] important factors that could cause actual results to differ materially from those in the forward-looking statement.” This means that it is enough to point to the principal contingencies that could cause actual results to depart from that projection.⁷⁹

In light of these observations, Judge Easterbrook then concluded that discovery was necessary to determine whether Baxter disclosed the principal or important risks known at the time of the disclosure. Although he assuaged issuers that they need not anticipate *all* potential sources of deviations from expectations,⁸⁰ this decision nevertheless clearly raises the bar as to what a defendant must show in order to secure safe harbor protection; specifically, Judge Easterbrook held that where the risk disclosed by the defendant is not identical to the negative contingency that came to pass, discovery is then necessary to determine whether the defendant disclosed the “principal risks” extant at the time of that disclosure.⁸¹ The use of the word *principal* is noteworthy here because it indicates a more rigorous standard for evaluating the sufficiency of cautionary language than what a plain reading of the statute would suggest in referring only to “important” facts.⁸² Indeed, at

75. *Asher v. Baxter Int’l Inc.*, 377 F.3d 727 (7th Cir. 2004).

76. *Id.* at 729–30.

77. *Id.* at 729.

78. *Id.* at 733.

79. *Id.* at 734 (second alteration in original).

80. *Id.*

81. *Id.* at 734–35.

82. It might also arguably contravene the legislative intent of Congress: “The Conference Committee specifies that the cautionary statements identify ‘important’ factors to provide guidance to issuers, and not to provide an opportunity for plaintiff counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made.” H.R. REP. NO. 104-369, at 43–44 (1995) (Conf. Rep.).

least one commentator has read the *Asher* decision to completely eviscerate the safe harbor, suggesting that plaintiffs,

with the benefit of hindsight, will be able to allege that some “important” or “principal” cautionary statements known to management were omitted, even if some “important” ones were included, thereby both avoiding dismissal at the pleading stage and achieving the opportunity to conduct the very extortionate discovery the PSLRA was intended to foreclose.⁸³

To the extent that this is true, *Asher* hence represents a welcomed move in the right direction as far as difficult-to-price securities are concerned. Although it is undoubtedly an important social goal to find ways to curtail “abusive” and “meritless” shareholder litigation,⁸⁴ in this particular context, allowing issuers to shield all forward-looking statements from legal liability with cautionary language to the effect that the predicted results, as represented to investors, may differ materially from actual results is not the way to go. As Judge Easterbrook astutely suggested,⁸⁵ what actual purpose do these predictions then serve—other than to confuse or obfuscate the true underlying risks of the financial instrument in the minds of investors very much susceptible to the behavioral limitations and shortcomings highlighted in Part III.A.3?

3. *The Behavioral Critique*

In a prospectus filed with the SEC, an issuer typically does not make precise statements about the probability of certain outcomes being realized.⁸⁶ Instead, the issuer discloses information that is considered

83. See Allan Horwich, *Is There a Breach in the Breakwater of the Statutory Safe Harbor for Forward-Looking Statements?*, WALL ST. LAW., Sept. 2004, at 19 (footnote omitted).

84. Congress enacted the safe harbor provisions in response to perceived widespread abusive securities litigation that, in its view, effectively served to “muzzle” corporate managers who were withholding useful information for “[f]ear that inaccurate projections will trigger the filing of securities class action lawsuits.” Private Securities Reform Act of 1995, [1995–1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,710, at 87,208 (Dec. 13, 1995).

85. See *Asher*, 377 F.3d at 734–35.

86. Safe harbor protection is not available for forward-looking statements “made in connection with an initial public offering.” 15 U.S.C. § 78u-5(b)(2)(D) (2006). Thus, although the spirit of this section still applies to forward-looking statements that do fall under the safe harbor, the discussion that follows is, technically speaking, more a critique of the bespeaks caution doctrine—which defendants do invoke in this context. See, e.g., Plaintiff’s Memorandum of Law in Opposition to Defendants’ Motion to Dismiss at 4, 26–29, 40, *Freidus v. ING Groep N.V.*, 736 F. Supp. 2d 816 (S.D.N.Y. 2010) (No. 1:09-CV-01049).

relevant in allowing investors to make their own determination as to how likely it is that the particular investment will or will not pay off; for instance, under Item 503(c) of Regulation S-K, the issuer is generally compelled to disclose risk factors that it believes an investor would consider relevant and important in formulating an assessment as to the future profitability of the given investment.⁸⁷ The behavioral critique of such disclosures, in the context of difficult-to-price financial instruments, is that these risk factors are generally insufficiently broad to allow for such a technical assessment, and moreover, where additional information and data are provided, many investors—even sophisticated professional investors—will still choose not to exert the logistical and analytical effort necessary to price these instruments correctly.⁸⁸

a. Disclosed Risk Factors Are Typically Insufficiently Broad

Consider the following disclosure filed by the Tribune Co. with the SEC in connection with the issue of exchangeable subordinated debentures due in 2029, exchangeable for cash based on the value of

87. See 17 C.F.R. § 229.503(c) (2010). Item 503(c) specifies that risk factors should clearly state the risk and indicate how that risk specifically affects the registrant, namely, registrants should not present risks that could generally apply to any issuer or to any offering. See *id.*

88. By examining the specific mechanisms by which traders processed public information, Gilson and Kraakman concluded that four types of trading operate to affect security prices, only one of which truly relies on the processing of a company's public disclosures; in particular, although traders might value firms based on generally known news, such as a Federal Reserve interest rate increase—"universally informed trading"—and others might value firms based on decoding a firm's stock price movements—"derivatively informed trading"—under their view, it is "professionally informed trading" that primarily relies on the processing of a company's public disclosures. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 567–79 (1984). "By searching for and processing a company's disclosures, professional traders use[] a combination of long and short strategies to move a company's price from its 'uninformed' price levels." Robert P. Bartlett, III, *Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis* 46 (Univ. of Cal., Berkeley Ctr. for Law, Bus. & the Econ., Working Paper No. 1585953, 2010). The speed with which informational efficiency is achieved thus depends on the distribution of disclosed information among professional traders and, in turn, on the costs investors face in acquiring, processing, and verifying that the information received is, in fact, correct. *Id.* The authors' responses to the various behavioral critiques set forth over the last twenty-five years of their particular view of how markets operate have tended to focus on the structural limits to arbitrage. See, e.g., Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 733 (2003). Although such structural limits to arbitrage are no doubt important, we argue that there are still good reasons to believe that even sophisticated professional traders—so important to informational efficiency under the Gilson-Kraakman view—may well be limited by the various types of cognitive deficiencies as suggested by the behavioral finance literature.

AOL common stock.⁸⁹ The prospectus dutifully cautions that the following risk factors should be considered carefully before purchasing the securities offered: that the return on the debt securities depends on the AOL common stock; the possible price illiquidity of the secondary market for the offered debt security; that the number of reference shares attributable to the debt securities will not adjust for some dilutive transactions involving the reference shares; the absence of covenant protection; the absence of a security interest in the AOL common stock; subordination to more senior debt; and competition with AOL.⁹⁰ Arguably, once an understanding of the debenture has been obtained upon reading the description of the security, these disclosed risk factors would appear self-evident to any investor seriously contemplating purchasing this debt. What is *not* so self-evident, however, is how an investor might use these disclosed risk factors to calculate a theoretical price for this particular exchangeable debenture, a calculation that, whatever the form, surely requires more than the simpleminded disclosure of a rambling inventory of vague and somewhat obvious risk factors.

Generally speaking, there appear to be two responses to the problem of forward-looking statements as they relate to the pricing of complex securities by investors: (1) as Judge Easterbrook suggested, require disclosure of all the “assumptions and calculations” underpinning the issuer’s projections or, better yet, the actual projected risk-reward profile derived by the issuer of the financial instrument, assuming it exists,⁹¹ or (2) rather than rely on a firm’s own assessment of its balance sheet or alternatively on the credit rating assigned to it by a potentially conflicted credit rating agency,⁹² require disclosure of *all* data and information relevant to the construction of risk-reward profiles and other formal risk models.⁹³ The first approach is unduly intrusive. The second works

89. Tribune Co., Prospectus Supplement Pursuant to Rule 424(b)(2) (SEC Registration No. 333-74961) (Apr. 9, 1999), <http://sec.gov/Archives/edgar/data/726513/0000950131-99-002188.txt>.

90. *Id.* at S7–S9.

91. *Asher v. Baxter Int’l Inc.*, 377 F.3d 727, 733 (7th Cir. 2004).

92. *See, e.g.*, Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis* (San Diego Legal Studies, Working Paper No. 09-015, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1430653; *see also* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999).

93. *See, e.g.*, Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 1503 (2009) (enacted) (requiring that the SEC “adopt regulations . . . requiring each issuer of an asset-backed security to disclose, for each tranche or class of

well with respect to easy-to-price securities; for the reasons given below, however, it does not work as well with respect to difficult-to-price securities.

b. Investors Cannot Map “Full” Disclosure onto “True” Price

In an interesting recent paper, Bartlett demonstrates that investors in monoline insurers showed little evidence of using a firm’s derivative disclosures to efficiently resolve uncertainty arising in connection with a monoline’s exposure to credit risk and concludes that to the extent that the complexity of CDOs—our prototypical difficult-to-price security—impeded informational efficiency, it was likely due to (1) the generally low salience of individual CDOs and (2) the logistical challenges posed in processing CDO disclosures.⁹⁴

With respect to these logistical challenges, Bartlett explores, in particular, the flawed calculation of loss estimates for Kleros Preferred Funding VI, a multisector CDO originated in June 2007 by Ambac—a monoline that invested in a portfolio of residential MBS, CDO, and other asset-backed securities (ABS).⁹⁵ The prospectus for Kleros VI was nearly 400 pages long.⁹⁶ Similarly, the disclosures pertaining to each of the 534 individual CDOs in the portfolio ranged from 300 to 400 pages in

security, information regarding the assets backing that security” and requiring “issuers of asset-backed securities . . . to disclose asset-level or loan-level data necessary for investors to independently perform due diligence”); COMM. ON CAPITAL MKTS. REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 151 (2009) (recommending enhanced disclosure by structured finance vehicles to “allow investors to complete their own credit analysis”); FASB Staff Position No. FAS 133-1 & FIN 45-4, *Disclosures About Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45 and Clarification of the Effective Date of FASB Statement No. 161*, FIN. STANDARDS ACCOUNTING BD. (Sept. 12, 2008), <http://www.fasb.org/jsp/FASB/Page/nr091208.shtml> (requiring enhanced disclosure requirements for sellers of credit derivatives and financial guarantees).

94. Bartlett, *supra* note 88, at 1 (reporting that “analysis of abnormal returns to Ambac . . . surrounding a series of multi-notch rating downgrades of its insured CDOs reveals no significant stock price reactions until Ambac itself announced the effect of these downgrades in its quarterly earnings announcements”); *see also* CHRISTOPHER CHABRIS & DANIEL SIMONS, *THE INVISIBLE GORILLA: AND OTHER WAYS OUR INTUITIONS DECEIVE US* 132–37 (2010) (arguing that the more comprehensive a prospectus seems, the less likely it is that investors will engage in additional research or exercise independent judgment); James J. Choi et al., *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds*, 23 *REV. FIN. STUD.* 1405, 1405 (2010) (rejecting “hypothesis that subjects buy high-fee index funds because of bundled nonportfolio services” and concluding that although search costs for fees matter, fees are not minimized, with subjects instead placing high weight on annualized returns since inception).

95. “Ambac had insured \$2.4 billion of the senior-most tranche of Kleros VI,” which was “one of Ambac’s largest CDO exposures.” Bartlett, *supra* note 88, at 34.

96. *Id.* at 42.

length.⁹⁷ In Bartlett's view, the failure of sophisticated investors to use a more detailed analysis of each of the CDOs' subordination and overcollateralization protections stems not so much from the analytical complexity of these provisions but from the logistical complexity of undertaking such an analysis; for example, time-related positioning and utilization of resources. The need to economize on time in view of a quickly changing market, Bartlett argues, likely contributed to the decision to avoid the delay and effort associated with locating over 500 individual prospectuses and hand-coding each such that the relevant data could then be inputted into the formal pricing model.⁹⁸

In addition to these logistical challenges, Bartlett cites the low salience of individual CDOs as another potential reason for why highly sophisticated arbitrageurs disregarded material information—information that they would have almost certainly been capable of understanding—in their analysis of the risks embedded in the derivative portfolio.⁹⁹ Reluctant to implicate analytic complexity, Bartlett argues that the omission is better understood as simply a failure to have appreciated the exposure to the various CDOs than as a failure to have fully grasped the underlying contractual complexity.¹⁰⁰ Overwhelmed by the rapid pace of news in early 2008, the argument is that the salience of a downgraded exposure could very easily have been overlooked by arbitrageurs trading in the market.¹⁰¹ Moreover, because the low salience of CDOs applies with equal or greater force to investors more generally, this thus suggests a second channel by which informational efficiency may have been impaired—specifically, in the face of compelling evidence, investors nevertheless remain uninformed of the underlying risks, thereby inhibiting arbitrageurs' ability to profit from their investments in research.¹⁰² In other words, arbitrageurs may have simply been unable to capture the attention of a marketplace otherwise distracted and washed away in a rising flood of often quite dire-seeming financial news.

97. *Id.*

98. *Id.*

99. *Id.* at 43.

100. *See id.*

101. *Id.*

102. *See* Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 655 (2003) (making the point that “a bargain that stays a bargain is no bargain”).

Although Bartlett's observations are undeniably important, the present Article departs from his analysis only insofar as we are not similarly unwilling to view analytical complexity as impeding informational efficiency. Even though this might all be semantics on some level in that the salience of a CDO and its analytic complexity are no doubt intimately related given that the complicated contracts defining the rights and obligations under the CDO are ordinarily embedded in a special-purpose entity whose name very often provides little indication of its economic size, function, or financial relevance, we do not, however, view all sophisticated investors as being like William Ackman, the chief protagonist in Bartlett's case study, who, for six years, had bet heavily on his ability to understand the risks associated with the monolines' entry into the structured finance market.¹⁰³

Understandably, Bartlett does not want to have to take the position that investors, such as Ackman, are simply incapable of pricing a CDO correctly. We do not either. Of course they can, but just like overcoming various logistical challenges, it requires the expenditure of costly effort. To the extent that investors deem this expenditure unprofitable and thus do not exert the required effort, it is then accurate to say that they do not know how to price the CDO. In other words, the CDO is not well understood not so much because investors intrinsically lack the technical know-how but rather because they have simply not taken the time and effort to use that know-how to perform the analysis required to compute a theoretical price for the CDO. In our analysis, the proper baseline, then, is not the Ackman who has already invested such effort but rather Ackman six years hence. Proceeding from this baseline, the claim, then, is that as the analytical complexity of a given security increases, fewer and fewer investors will choose to invest the effort required to analyze and fully understand the prospectuses and relevant forward-looking statements contained therein. In the context of difficult-to-price securities, the number is so few—so we argue—that the markets for these securities, which are already fairly illiquid to begin with, do not have the relevant mechanisms in place necessary to attain the efficient price equilibrium point.¹⁰⁴

103. See Bartlett, *supra* note 88, at 42. William Ackman was the founder of Pershing Square Capital, a hedge fund that had accumulated large short positions in Ambac. Since 2002, Ackman had been the monoline industry's most vocal critic, publishing a number of reports questioning Ambac's high credit rating. See Alistair Barr, *Pershing's Ackman Knocks MBLA, Ambac*, WALL ST. J. MARKETWATCH, May 24, 2007, <http://www.marketwatch.com/story/hedge-fund-manager-says-mbia-ambac-exposed-to-subprime-fallout>.

104. For a more detailed and perhaps more compelling articulation of a similar point, see Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. ILL. L. REV. 1, 19 (2004), which argues that many legitimate transactions resulting in the issuance of securities are "so complex that less than a critical mass of

B. Getting the Incentives Right

We now turn to what it means to say that an investment bank must retain the possibility of incurring “real losses” in selling difficult-to-price financial instruments. In theory, there appear to be two principal mechanisms by which to achieve this objective: (1) the implementation of high-powered compensation schemes or (2) the adoption of partnership-like ownership structures. Most proposals for reform have tended to focus on the former.¹⁰⁵

In our view, however, the problem with focusing on compensation is that these contractual arrangements essentially leave unaddressed the two sources of uninformed risk-taking identified above. Although there do exist examples where advisers incur actual monetary losses if the trading book is in the red, thereby addressing the house money effect—so-called fulcrum fees arrangements that permit investment advisers to adjust base advisory fees depending on how the fund performs relative to a stipulated market index¹⁰⁶—these fee structures are not popular in practice.¹⁰⁷ Moreover, for obvious reasons, it will not be easy for a

investors can understand them in a reasonable time period” and “the market will not reach a fully informed price equilibrium, and, hence will not be efficient.”

105. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 205–06 (2004); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers’ Pay*, 98 GEO. L.J. 247, 287 (2010); Kose John et al., *A Theory of Bank Regulation and Management Compensation*, 13 REV. FIN. STUD. 95, 96 (2000); see also BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS 26–27 (2006), available at <http://www.bis.org/publ/bcbs128.pdf> (requiring banks to provide comprehensive and timely information about their compensation practices and procedures).

106. See 15 U.S.C. § 80b-5(b)(2) (2007).

107. See, e.g., Jesse Eisinger, ‘No Excessive Pay, We’re British,’ WALL ST. J., Feb. 8, 2006, at C1 (reporting that although the average rate of increase for a CEO’s compensation package in the United Kingdom was around 6% in 2005, it was more than 13% in the United States from 2003 to 2004). Despite the difference in compensation, the United Kingdom’s annual return for its top 100 companies averaged 6.5%, while the U.S. Dow Jones Industrial Average trailed behind at 2%. *Id.* There are at least two distinct reasons for their limited use. First, the SEC has promulgated extensive regulations relating to when fulcrum fees may be considered fair, which, of course, as a consequence, has given fund managers pause for fear that their particular compensation structure will be deemed “unfair” by the SEC. See generally CLIFFORD E. KIRSCH, INVESTMENT ADVISER REGULATION: A STEP-BY-STEP GUIDE TO COMPLIANCE AND THE LAW § 9:4.3[B], at 9–17 (2d ed. 2007) (expanding upon the factors the SEC considers to determine the fairness of fulcrum fees, including the fairness of the size of the fee, the index used to determine performance for the fee, and the time period over which such performance is calculated). With similar effect, the SEC has also shown a willingness to undertake enforcement actions calling into question the “specified period” over which

public corporation to implement an employment compensation scheme whereby employees run a distinct risk of earning *negative* income in a given year. Even if this were possible, there would still remain unaddressed the second source of uninformed risk-taking, namely, the earned money effects that predictably arise where trading is conducted with funds that do not meaningfully constitute earned money.

1. The Return of the Private Investment Banking Partnership

There is an obvious solution to this problem, however—the return of the private investment banking partnership. Indeed, we argue for exactly such as the optimal means by which to properly incentivize issuers/underwriters of difficult-to-price financial instruments to engage in nonexcessive, suitably well-informed risk-taking behaviors.¹⁰⁸ In many respects, the investment banking partnership is not a terribly novel solution. Prior to 1970, the New York Stock Exchange explicitly prohibited the incorporation of investment banks.¹⁰⁹ It was only after this ban was repealed that the large investment banks turned, en masse and over time, from a partnership model—where senior employees owned the company and were responsible for all of its liabilities and received all of its profits—to a public ownership model.¹¹⁰ The argument advanced in this

the asset value of the fund under management must be averaged. *See, e.g.*, Dreyfus Corp., Investment Advisers Release No. 2549, File No. 3-12413, at 4 (Sept. 7, 2006), available at www.sec.gov/litigation/admin/2006/ia-2549.pdf (reimbursing the fund over \$3 million after SEC alleged Dreyfus incorrectly calculated its fee by measuring it against its fund's daily net asset value instead of the averaged asset value of the fund over the thirty-six month performance period). Second, although admittedly a question of empirical fact, it appears that fund managers prefer no-incentive plans to symmetric incentive plans. This being true, in proscribing asymmetric incentive plans without also drawing any distinction between flat no-incentive schemes and symmetric incentive plans, the regulation thus had the unfortunate and yet entirely predictable effect of compelling managers to switch not to symmetric incentive plans as intended—arguably better in terms of total investor welfare—but rather to no incentive plans—arguably worse in terms of total investor welfare.

108. The focus on ownership structure is supported by a formal literature on hedge funds that has shown that risk-taking is greatly reduced if a substantial amount of the manager's own money—at least 30%—is in the fund as well. *See* Roy Kouwenberg & William T. Ziemba, *Incentives and Risk-Taking in Hedge Funds*, 31 J. BANKING & FIN. 3291, 3291–93, 3307 (2007); *see also* Laura T. Starks, *Performance Incentive Fees: An Agency Theoretic Approach*, 22 J. FIN. & QUANTITATIVE ANALYSIS 17, 17–20 (1987).

109. *See* James Surowiecki, *Public Humiliation*, NEW YORKER, Sept. 29, 2008, at 30.

110. Joint ownership continues to be the manner by which most hedge funds are organized today. *See, e.g.*, Carl Ackermann et al., *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 J. FIN. 833, 833–34 (1999). The fact that hedge fund managers typically risk both their own money and their reputation as shrewd money managers in running a fund is a positive sign to outside investors. *Id.* at 834. The personal involvement of the manager, coupled with a profitable and verifiable track record, likely explains why

Part proceeds by first considering in detail how the incentives confronted by a proprietary trading firm differ under the two respective ownership regimes.

a. Proprietary Trading Within a Private Partnership

Generally speaking, the “production function” of proprietary trading involves two main capital inputs: (1) access to financial capital and (2) human capital.¹¹¹ In a partnership, the latter is bound to the firm by the structure of partnership agreements that, in conjunction with an inventory of securities held by the firm, provides the basis for loans used to fund the firm’s broker-dealing and trading, with this inventory of securities, in particular, generally used as collateral by the firm to obtain overnight or short-term financing.¹¹² In addition, the firm will also have general unsecured debt obligations for which the general partners have unlimited liability.¹¹³ As for personnel management, the firm typically makes “up or out” decisions for nonpartner employees four to seven years after they have joined the firm.¹¹⁴ If asked to join the partnership, compensation tends to consist of a relatively small base salary and a potentially large annual performance-based bonus.¹¹⁵ For general and limited partners, these bonuses do not represent pure income, however: general partners typically have a mandatory plowback ratio of 80%, with the ratio for limited partners somewhat lower—by this means creating a strong incentive for these relatively asset-rich/cash-poor partners to remain productive long after they have been admitted into the partnership.¹¹⁶

From the perspective of agency theory, the liabilities of these firms, in economic terms, are (1) collateralized and unsecured debt obligations

outside investors are so eager to invest in hedge funds, even though investors generally receive very limited information about the hedge fund’s proprietary investment strategies and face significant liquidity constraints in the form of multiyear lockup periods and nondecreasing redemption fees.

111. See Bruce N. Lehmann, *Corporate Governance and Hedge Fund Management*, 91 *ECON. REV.*, No. 4, 2006 at 81, 82.

112. *Id.* at 82.

113. *Id.* at 84. The asset side of the balance sheet of the proprietary trading desk, V_A , typically has three components: “[T]he value of the long positions (V_L), cash on hand devoted to margin requirements (C_M), and uncommitted cash (C_U)”; that is, more formally: $V_A = V_L + C_M + C_U$. *Id.*

114. *Id.* at 83.

115. *Id.*

116. *Id.* at 84.

and (2) an implicit claim on human capital in the form of the general and limited partners.¹¹⁷ With respect to the latter, creditors can reasonably rely on these equity holders in the firm to make money over the long-term for at least three related reasons: (1) human capital is bound to the firm by the plowback provisions of the partnership agreement, (2) partnership shares are valued at cost until sometime around retirement, further binding the partners to the firm, and (3) more productive partners very often receive higher fractional ownership through the bonus system, “ensuring that the best traders and investment bankers serve[] on the important committees, and, thus, closely over[see and direct most of the important] business activities of the firm.”¹¹⁸

b. Proprietary Trading Within a Public Corporation

Proprietary trading within a public corporation, by contrast, differs in two significant ways¹¹⁹: (1) the opportunity cost of capital falls because idiosyncratic risk is now spread out over a diversified shareholder base,¹²⁰ and (2) important agency problems now surface as a consequence of the separation of ownership and control,¹²¹ which, because of the nature of proprietary trading, are qualitatively very different from those that exist within a typical public corporation—in particular, the lack of transparency with respect to profitability, risk, exposure, liquidity, and leverage in proprietary trading under the corporate form creates substantial problems

117. *Id.*

118. *Id.*; see also Alan D. Morrison & William J. Wilhelm, Jr., *Partnership, Reputation, and Human Capital*, 94 AM. ECON. REV. 1682, 1682–83 (2004) (discussing the nature of human capital within the form and function of business organizations).

119. The asset side of the balance sheet is identical to that for proprietary trading under private partnerships; that is, one cannot look at the trading books of, say, a convertible arbitrage or a short or long/short portfolio or a short-term event-driven strategy and potentially discern the underlying governance structure.

120. See, e.g., Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 329 (1983) (“Common stock allows residual risk to be spread across many residual claimants who individually choose the extent to which they bear risk and who can diversify across organizations offering such claims.”).

121. See, e.g., *id.* at 327 (defining the term *agency costs* as the “costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests”); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301–03 (1983). Interestingly, Professors Berle and Means first conceived of the problem somewhat differently, not in terms of agency but rather in terms of the absence of shareholder control or power over the affairs of the corporate enterprise. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 86–89 (1932) (making the point that the ability of shareholders to elect directors and thereby control management was relatively meaningless in the context of the large corporation because management controlled the proxy machinery and hence ultimately the outcome of the election).

for external monitors.¹²² Although compensation in the form of performance-based bonuses and executive stock options do mitigate these problems to a certain extent, without explicit external monitoring, these high-powered compensation schemes are likely to serve but as imperfect substitutes for direct monitoring—especially in those times when good governance is needed most—where a firm is confronted with actual or pending losses the sizes of which are capable of plunging the entire firm into financial distress, with the ensuing feelings of helplessness and despair, resulting in all of the characteristic outcomes of poor managerial decisionmaking—“the myopic focus on short-term gains” at the expense of long-term sustainability and the tendency “to allocate scarce capital resources to excessively risky,” low-probability-of-a-large-gain-type strategies.¹²³

In addition, the corporate analogues of the full and limited partners can now be characterized as relatively cash-rich/asset-poor—in terms of firm-specific assets—with human capital in the form of trading skill no longer bound to the public corporation as it was under the private partnership. Indeed, under the corporate form, the human capital of proprietary traders is best conceived as a tangible asset that can be freely transferred across the different firms. As a result, notwithstanding the effect of high-powered compensation schemes, shareholders must primarily look to the franchise value—the value of the brand or the reputation of the investment bank—in order to properly incentivize and retain its pool of valuable human capital.¹²⁴

2. Two Arguments Against Structuring Investment Banks as Private Partnerships

From the preceding discussion, two general, somewhat related objections emerge as responses to the claim that investment banks should be structured as private partnerships: (1) that unlimited liability results in an insupportably high cost of capital, and (2) that even if steps are taken to minimize the costs of unlimited liability, the capital

122. See Lehmann, *supra* note 111, at 84.

123. *Id.* at 84–85.

124. See Charles Fombrun & Mark Shanley, *What's in a Name? Reputation Building and Corporate Strategy*, 33 ACAD. MGMT. J. 233, 252 (1990); see also Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1045–46, 1062 (1990); David M. Kreps & Robert Wilson, *Reputation and Imperfect Information*, 27 J. ECON. THEORY 253, 253, 275 (1982).

structure of the private partnership is still such that the cost of capital is sufficiently high as to preclude the possibility of investment banks, *as presently structured*, turning back to the partnership structure of yore. The virtues of each of these objections are addressed in turn.

a. The Cost of Unlimited Liability

Under the partnership structure, the general partners, as well as those limited partners with control responsibilities, are exposed to unlimited personal liability.¹²⁵ The strengthening of incentives flowing from the partnership structure, and in particular, unlimited liability, does come at a cost, however; specifically, as compared with the public corporation, the principals must bear more fund-specific risk because their personal wealth is now more strongly and positively correlated with the fortunes of the firm, and thus, unlike in a public corporation, the opportunity cost of capital or, equivalently, the required rate of return on equity will typically be higher because it depends on total risk, not just systemic or market risk.¹²⁶

The increased cost of capital implied by unlimited liability can be easily reduced, however, if not eliminated altogether, by readily available legal technology; in particular, under the corporate law of most states, partnerships can create a limited liability corporation to serve as the general partner, with the individual partners now serving as limited partners.¹²⁷ Although this corporate structure does effectively serve to limit the overall liability exposure of the partnership, note that in so doing, it also, of course, serves to attenuate or eliminate the positive incentive effects associated therein.

125. See, e.g., Delaware Revised Uniform Limited Partnership Act, DEL. CODE ANN. tit. 6, § 17-303(a) (2005) (holding limited partner liable for the obligations of the limited partners if the partner participates in control or management of the business of the limited partnership).

126. See Paul Halpern et al., *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117, 133, 147 (1980); see also Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 94, 101 (1985). But see Peter Z. Grossman, *The Market for Shares of Companies with Unlimited Liability: The Case of American Express*, 24 J. LEGAL STUD. 63, 85 (1995) (rejecting the theory that an efficient capital market with diversified shareholders cannot exist without limited liability); Henry Hansmann & Reinier H. Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); Mark I. Weinstein, *Don't Buy Shares Without It: Limited Liability Comes to American Express*, 37 J. LEGAL STUD. 189, 224 (2008).

127. Indeed, Goldman Sachs, the last of the major Wall Street partnerships to go public, was organized in this manner well before its initial public offering in 1998. Lehmann, *supra* note 111, at 86.

b. The Cost of Sticky Equity Capital

Even if the preceding steps are taken to minimize the costs of unlimited liability because of the illiquid nature of most equity purchases by—and awards to—the partners, the equity capital of a private partnership is still likely to be relatively more sticky—and thus more costly—than that of a general public corporation. Again, there are steps that can be taken to lower these liquidity costs; for instance, the liquidation of individual partnership interests can be made subject to a variety of constraints: noncompete agreements, deferred payouts over a number of relevant fiscal periods, an aggregate limit on redemptions, minimum capital covenants, and net capital requirements. In addition, the partnership can look to noncontrolling minority interests and founding/working partners' capital as additional ownership interests available to support the assets on its balance sheet.

Nonetheless, it likely remains true that the opportunity cost of capital implicit in the partnership form will generally be higher than that for a similarly situated public corporation.¹²⁸ Indeed, this difference is perceived by many as being so large as to effectively preclude the possibility of investment banks, *as presently structured*, returning to the partnership structure of yore. The claim made here, however, is that this point is entirely misplaced insofar as it assumes a legitimate need to maintain the current organizational structure of the modern investment bank. But just what is this legitimate need? Why cling so stubbornly to this assumption? The modern investment bank appears a mishmash of financial activities, resulting in ill-informed risk-taking behaviors and characterized by a host of significant conflicts of interest—in which clients seem always to find themselves on the losing end—and having a haphazard interconnectedness that serves, often exclusively so, to increase overall systemic risk within the financial system. If this ill-conceived hodgepodge cannot be supported as a private partnership, well, then so be it.¹²⁹

128. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 349 (1976) (setting forth the agency cost framework's bedrock premise—that diversified shareholders are cheapest cost risk bearers); *cf.* Morrison & Wilhelm, *supra* note 118, at 346–49 (setting forth a technological innovation theory of a partnership's decision to go public).

129. Along these lines, when Goldman Sachs debated going public, former senior partner John Whitehead made the critically important point that limits on capital are not necessarily bad, suggesting that “[c]apital should be a restraint. It helps you make

In what follows, we provide an in-depth look into how an investment bank might respond if it were denied access to relatively low-cost financial capital, and we catalog in detail those business lines that would likely continue to be offered and those that would not. In our view, what thus constitutes investment banking at the end of this exercise represents a far more sensibly organized entity than the smorgasbord of mismatched financial enterprises into which modern investment banking has seemingly arbitrarily evolved over the past forty-odd years.

i. Investment Banking

Without access to low-cost capital, the investment bank, organized as a private partnership, could, of course, by definition, continue to manage and participate in public offerings and private placements of debt—originating, structuring, and executing debt/debt-related financing and structuring, and executing liability-based risk-management strategies for corporations, financial sponsors, and government-sponsored entities—and equity—originating, structuring, and executing public and private equity, equity-linked, and derivative financing. The investment bank could also continue to provide investment advisory and financial planning services to its corporate clients, including advice and analysis on mergers and acquisitions, divestitures, joint ventures, corporate restructurings, recapitalizations, spin-offs, exchange offers, and leveraged buyouts, as well as shareholder relations.¹³⁰ On the other hand, there would likely be little, if any, corporate lending, with investment banks having to reduce substantially the extent to which they extend loans and make other lending commitments, including, for instance, bridge financing to select corporate clients and full service commercial mortgage lending in the form of nonrecourse first mortgages and mezzanine financing.

ii. Private Wealth and Asset Management

Despite the presence of certain inescapable conflicts of interest strongly militating against it so doing, the investment bank could, in

selections. You have to make choices. We can't do leveraged buyouts and arbitrage—or we can do a little of each.” LISA ENDLICH, GOLDMAN SACHS: THE CULTURE OF SUCCESS 9 (1999).

130. To wit, as Goldman contemplated its IPO, a powerful contingent of investment banking partners, including many in the mergers and acquisitions department that had generated huge profits in fees, did not sign off on this particular vision of the future presented by partners Stephen Friedman and Robert Rubin, namely, the expansion of trading and principal risk. *Id.*

theory, continue to operate on the “buy-side,”¹³¹ with the bank, for example, continuing to provide private wealth management, such as cash management services, including cash sweeps, debit cards, electronic bill payments, and check writing. It could also continue to provide lending products, albeit presumably on a much more limited basis, including securities-based lending, mortgage loans, and home equity lines of credit. The investment bank could also provide asset management, employing portfolio managers to run investment products ranging from money market funds to equity taxable or tax-exempt bond funds in both developed and emerging markets. Similarly, institutional investors would still be able to invest through the bank in several alternative investment platforms, including hedge funds, funds of hedge funds, funds of private equity funds, and portable alpha strategies. As for merchant banking activities, however, the bank would very likely have to reduce substantially the number and scope of products offered, including, for instance, real estate and technology principal investments, private equity funds, infrastructure investing groups, or other such urban and economic development initiatives.

iii. Sales and Trading

The impact on sales and trading of more limited access to financial capital is the most difficult to predict. As noted above, the investment bank will continue to participate in equity and fixed income issuing and underwriting, and therefore to a certain extent, it will also continue to engage in securities trading because investors generally expect investment banks to make a market in the securities that it issues/underwrites. It will likely do so, however, only insofar as it can predominantly act as an intermediary in the primary market, with the bank taking on limited balance sheet risk; that is, the bank will likely try to confine itself to the role of principal, who, in sales transactions, matches buyers and sellers with little, if any, gap between the two sides in delivery-versus-payment settlement and who similarly, in “give up” transactions, arranges trades

131. Recall that the exercise is only to determine what activities will decrease significantly or cease altogether as a result of the higher cost of capital. Although we believe that investment banks should not be operating on the “buy-side” because of the important conflicts of interest that invariably arise in doing so—and, indeed, investors are increasingly demanding that banks’ brokerage services be segregated from asset management—that argument is deferred until Part IV.

between third parties, with the negotiated terms executed directly between the corresponding buyer and seller.¹³²

Pure proprietary trading on a large scale, however, is very unlikely to take place. The bank's capital has to support a large matched book business.¹³³ Although unmatched or open positions, of course, must be held temporarily to facilitate customer flows, the trading strategies actually pursued by the investment bank are unlikely to be the sorts of event-driven—merger arbitrage or the purchasing of distressed securities—or directional—long/short equity, global macro or CTA/managed futures—arbitrage strategies typically employed by proprietary traders. Because of the high opportunity cost of capital, the bank will be reluctant to structure its various trading desks such that trading intermediation is no longer the primary activity.¹³⁴ In other words, the claim is that as capital levels decrease relative to the size of the bank's balance sheet as a result of increased proprietary trading—and leverage correspondingly increases—the partnership, whose own hard-earned money is now at stake, will deem such trading on its own account too risky an activity to be actively pursued on a relatively sizeable scale.

Investment banks, it should be noted, will of course not particularly welcome their proprietary trading activities restricted in this manner. These activities can be enormously profitable for banks.¹³⁵ But simply because an activity is enormously profitable does not necessarily mean that it should be encouraged or allowed, especially where this activity is not essential to the functioning of an investment bank—as we understand that term to mean in this Article. Indeed, a large part of why proprietary trading is so profitable for a bank is that it allows it to put on leverage vis-à-vis its own capital account. Despite the fact that this leverage works to magnify the range of feasible profits for the firm,¹³⁶ it

132. See *Fitch Affirms Cantor Fitzgerald's Long-Term IDR at 'BBB'; Outlook Stable*, BUS. WIRE, May 6, 2010, <http://www.businesswire.com/news/home/20110506005980/en/Fitch-Affirms-Cantor-Fitzgeralds-Long-Term-IDR-BBB>. In terms of risk management, “counterparty risk”—to the extent that it exists as a result of the bank's market-making activities—“will likely be well-managed through client selection, netting and collateral agreements, and [the] use of [public] exchanges.” *Id.* Furthermore, it would not be surprising to see (1) trading limits established on internal risk-ratings, anticipated estimated trading activity, and potential exposure to the instruments traded; (2) the client base diversified in each of the main product segments; and (3) aggregate customer exposures closely monitored for disproportionately large concentrations.

133. See *id.*

134. See *id.*

135. For example, on average around 68% of Goldman Sachs's revenues and profits in 2008 were derived from its proprietary trading desks. See Christine Harper, *Goldman Had More Trading-Loss Days than Morgan Stanley, Lehman*, BLOOMBERG (Apr. 9, 2008), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akv.Eg65H9DI>.

136. To see the power of leverage, consider the following example: Suppose an investor purchases \$100,000 of stock *X* using \$50,000 margin and \$50,000 cash. The price of stock *X*

can also put the firm at existential risk—a risk that is altogether unnecessary—for in order to engage in the types of market-making activities described above, there is no practical reason why an investment bank needs to be so highly leveraged—other than the fact that it makes more money for its traders. It does not help clients. It is not necessary for the effective operation of other parts of the firm. Given that investment banks, such as Goldman Sachs, typically pay out nearly half of all profits earned to their employees—as compared with 20% in a typical hedge fund—it is not even clear that it is beneficial for the shareholders whose very equity is being leveraged in the first place.¹³⁷

Finally, similarly unclear is the extent to which investment banks will continue to engage in prime brokerage and repo/securities lending. Although it is certainly plausible to imagine banks providing consolidated clearance, settlement, custody, operational and administrative support, capital introduction, and portfolio reporting services to various institutional clients across multiple asset classes,¹³⁸ it is less clear whether such firms will choose to finance the investment strategies of third-party investment entities by providing prime brokerage and repo/securities lending services. It will likely depend on the term structure of the financing, as well as on the risk exposure of the collateral and counterparties involved from a credit perspective. But in general, these are often highly capital-intensive businesses that use up a significant chunk of the balance sheet. For example, to the extent that its prime brokerage provides financing primarily through loans secured by the long positions of its hedge fund clients, the bank is exposed to the risk of loss if the value of the collateral held as security declines below the loan value and the client is unable to repay

then increases 50%. The investment is now worth \$150,000. If the investor cashes out at this point, then after paying back the \$50,000 originally borrowed, the investor is left with \$100,000, of which \$50,000 is profit—a 100% return even though stock *X* only went up by 50%. Leverage has allowed us to effectively double the rate of return on stock *X*. Of course, the same can be said of potential losses.

137. See Alan Schram, *Financial Crisis Worked Out Well for Goldman Sachs*, HUFFINGTON POST (Oct. 15, 2009, 9:12 PM), http://www.huffingtonpost.com/alan-schram/financial-crisis-worked-o_b_323184.html.

138. To the extent that private investment banking partnerships do *not* engage in large-scale proprietary trading, such firms may actually have a competitive advantage as compared with publicly incorporated broker-dealers or commercial banks in satisfying the demand for these services insofar as there is less opportunity to profit from access to the corresponding retail flow.

the deficit. Accordingly, like proprietary trading, prime brokerage may very well be considered too risky to be pursued on a large scale.¹³⁹

In short, recall that the import of all of this is to provide some sort of comprehensive response to the claim that the higher cost of capital implied by the partnership form will preclude the modern investment bank from operating as presently structured. As the preceding discussion illustrates, we fully agree—but only insofar as the claim relates to investment banks *as presently structured*, for we then ask the question, Is this particular structure really the most sensible? Is it really to be preferred to the perfectly viable structure outlined above that, in our view, likely emerges where an investment bank is compelled to organize itself as a private partnership? As the following discussion will hopefully continue to make clear, we think not.

3. *Two Arguments for Structuring Investment Banks as Private Partnerships*

In addition to better addressing the agency problems that stem from the separation of ownership and control, there are two additional arguments that can be made to support the claim that investment banks should be structured as private partnerships: organizing as such (1) reduces systemic risk in the financial system and (2) weakens the conflicts of interest inherent wherever a financial firm simultaneously pursues both sales and trading of securities.

a. Reducing Systemic Risk in the Financial System

One question that might conceivably arise from all of this is, Are we advocating a position that has as one of its consequences an investment banking sector that is dangerously exposed to market risk insofar as firms now lack the capital necessary to pursue expansion along a number of different business lines? All else equal, this may be true; but all else is not equal. With expansion tends to come greater credit and liquidity risk.¹⁴⁰ Moreover, as the total risk borne by investment banks increases, on net, the number of firms operating within the appropriately defined market correspondingly likely decreases, and as the size of these firms increases and the total number of competitors decreases, the financial system, more generally, is now forced to address important “too big to

139. In our view, prime brokerage and securities lending programs are better left to traditional commercial banks or publicly incorporated broker-dealers.

140. See GARY H. STERN & RON J. FELDMAN, *TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUT* 64–65 (2004) (arguing that “after becoming larger, banks ‘spend’ their diversification benefit by taking on additional risk”).

fail” type issues,¹⁴¹ with the relevant empirical evidence providing little support for the proposition that large banks enjoy significant economies of scale—above what is actually a very low size threshold.¹⁴² In other words, to the extent that the adoption of the partnership structure results in a greater number of smaller firms, that is, lower market concentration, it contributes to the reduction of systemic risk in the financial system, and it does so without incurring the cost of expansive systematic scale inefficiencies.

As a result, the proposed framework thus implements, albeit indirectly, one of the policy proposals included within the Volcker Rule as outlined above, namely, that a financial firm not be allowed to acquire another company if the resulting firm would incur more than 10% of the liabilities of the financial system.¹⁴³ Notwithstanding the obvious difficulties involved in providing some kind of substantive meaning to the phrase *liabilities of the financial system*, note that it remains to be explained why ten is the right number and not, say, five or fifteen. Rather than attempt to defend what might be justifiably criticized as an arbitrarily chosen threshold, however, a generally similar result obtains not through narrow legislative bright-line rules but rather by encouraging the adoption of a particular ownership structure; that is, a more palatable market concentration in terms of overall financial stability can be achieved not as the narrowly defined objective of a

141. The phrase *too big to fail* corresponds to the notion in financial regulation that the largest and most interconnected businesses are so large and so big that a government cannot allow them to declare bankruptcy because such failure would have a debilitating effect on the overall economy. See SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 208 (2010) (arguing forcefully that the solution to the “too big to fail” problem is obvious: “do not allow financial institutions to be too big to fail; break up the ones that are”).

142. A review of multiple empirical studies found that economies of scale vanish at some point above \$10 billion in assets. See Dean Amel et al., *Consolidation and Efficiency in the Financial Sector: A Review of the International Evidence*, 28 J. BANKING & FIN. 2493, 2500 (2004); see also Stephen A. Rhoades, *A Summary of Merger Performance Studies in Banking, 1980–93, and an Assessment of the “Operating Performance” and “Event Study” Methodology*, 167 BOARD GOVERNORS FED. RES. SYS. 7 (1994), available at <http://www.federalreserve.gov/pubs/staffstudies/1990-99/ss167.pdf> (explaining that operating performance and event studies result in an overall conclusion that bank mergers do not generally tend to result in efficiency gains); Allen N. Berger & David B. Humphrey, *Bank Scale Economies, Mergers, Concentration, and Efficiency: The U.S. Experience* (Wharton Fin. Inst. Ctr., Working Paper 94-24, 1994), available at fic.wharton.upenn.edu/fic/papers/94/9425.pdf (discussing that scale economies in banking are not found to be materially important, except for the smallest banks).

143. *Volcker Rule*, *supra* note 4, § 13a.

particular piece of legislation but rather as the byproduct of a more expansive regulatory framework involving the appropriate ownership structure for investment banks suitably defined.

Further contributing to overall financial stability, it follows that investment banks structured as partnerships will be less susceptible to the sorts of dramatic runs on the bank—which led, for example, to the demise of the venerable investment banking firm Bear Stearns in the spring of 2008¹⁴⁴—for at least two reasons: (1) more liquid balance sheets and (2) immunity from the pressures of frenzied short-selling.

First, the partnership structure should result in a more liquid balance sheet. On the asset side of the balance sheet, for the reasons discussed above, investment banks should be much less willing to invest in long-term illiquid assets. To the extent that they do so, they should be much more serious about hedging the consequent risks over the long-term; for example, instead of bearing the credit risk themselves, they should work with financial insurance companies to structure credit default swaps that allow the credit risk to be transferred off of their balance sheets and onto the balance sheets of firms better able to bear such risk, namely, insurance companies. Similarly, on the liability side, in financing the balance sheet, not only should investment banks be less willing to rely on short-term financing—which is dangerously susceptible to margin calls and nonrenewals without notice¹⁴⁵—but also the liabilities that are incurred will very likely be less liquid as banks choose to decrease, or no longer hold, “demand deposits” in the form of cash balances of asset management and private wealth clients and move to decrease, or stop entirely, the practice of rehypothecating the securities, pledged by these clients, so as to further leverage the balance sheet.

Second, because the shares of a private investment bank partnership will not be publicly traded, the bank will be shielded from the pressures of frenzied short-selling. Although it is readily accepted that short-selling, in principle, plays a critically important role in any well-functioning capital market, often applying much-needed downward pressure on security prices that have become overvalued, it must be similarly admitted that it can also serve to ignite and spread a dangerous and infectious panic among those who daily participate in these markets.¹⁴⁶

144. See WILLIAM D. COHAN, *HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET* 17–25, 42–53, 69–74, 244–54 (2009).

145. See generally Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–2008*, 23 *J. ECON. PERSP.* 77 (2009).

146. For example, Citigroup Inc. CEO Vikram Pandit several times suggested to the Congressional Oversight Panel overseeing the funds from the government bailouts that short-sellers were partially to blame for the bank’s near collapse in the fall of 2008. See Tom Braithwaite & Alan Rapoport, *Pandit Blames Citi’s Woes on Short Selling*, *FIN.*

That is, assuming that information cascades exist, that investors “rationally herd,”¹⁴⁷ and that prices can and do overshoot and undershoot their true value—contrary to the precepts of the efficient market hypothesis—especially in periods of high market volatility, short-selling “can, in theory, drive a company’s stock price well below fundamental value” and hold it there for a nontrivial amount of time.¹⁴⁸ This is particularly true for financial institutions, whose stock price is intimately related to the underlying business. For these financial institutions, highly concentrated short-selling is capable of materially disrupting the ordinary course of business by inspiring fear and doubt among a variety of different market actors, including depositors, investors, lenders, and other assorted counterparties.¹⁴⁹ To the extent that this results in greater systemic risk within the financial system, the partnership structure hence reduces such risk by affording investment banks a surely much-appreciated refuge from the assaults of these disruptive, and potentially destabilizing, market forces.¹⁵⁰

b. Better Balancing the Conflict of Interest that “Sales and Trading” Suggests on Its Face

Perhaps the strongest argument, however, in favor of the partnership structure is that it appears to strike exactly the right balance in resolving the conflict of interest that invariably arises between proprietary trading and sales. Although it is widely recognized that the modern investment

TIMES (Mar. 5, 2010, 2:00 PM), <http://www.ft.com/intl/cms/s/0/2f988dc0-2796-11df-b0f1-00144feabdc0.html#axzz1UiE0iHYX>.

147. See generally Mark Grinblatt et al., *Momentum Investment Strategies, Portfolio Performance, and Herding: A Study of Mutual Fund Behavior*, 85 AM. ECON. REV. 1088 (1995); John R. Nofsinger & Richard W. Sias, *Herding and Feedback Trading by Institutional and Individual Investors*, 54 J. FIN. 2263 (1999); Brett Trueman, *Analyst Forecasts and Herding Behavior*, 7 REV. FIN. STUD. 97 (1994); Russ Wermers, *Mutual Fund Herding and the Impact on Stock Prices*, 54 J. FIN. 581 (1999).

148. See James Surowiecki, *The Short-Selling Question*, NEW YORKER, Nov. 24, 2008, <http://www.newyorker.com/online/blogs/jamessurowiecki/2008/11/the-shortsellin.html>.

149. *Id.* (“[T]he declining stock price wasn’t simply an epiphenomenon of the problems with Citigroup’s business: the declining stock price actually exacerbated those problems.”).

150. It is true the funds could still experience runs in the form of margin calls and redemption requests. The argument is not that the private partnership structure precludes entirely the possibility of a liquidity crisis but rather is that it eliminates an important signal often serving to ignite what are often irrational-seeming losses in confidence in the solvency of the firm’s balance sheet.

bank is riddled with significant conflicts of interest¹⁵¹—suggestive, perhaps, of the unnaturalness of this particular corporate form—including (1) corporate issuance versus research,¹⁵² (2) sales/trading versus research,¹⁵³ (3) asset management versus brokerage,¹⁵⁴ and (4) proprietary trading versus nonproprietary trading, including “front running” and trading as principal against an uninformed retail flow,¹⁵⁵ the specific conflict of interest at issue here—which has been relatively underemphasized in the academic literature on investment banking—is the conflict of interest that arises where an investment bank issues/underwrites securities, on the one hand, and, on the other hand, trades in these very same securities for its own proprietary account. In other words, we assert that this combination of activities, which investment banks proudly describe as one of their core functions, namely, sales and trading, suggests, on its face, an intrinsic conflict of interest that if not to

151. See, e.g., Erik Sirri, *Investment Banks, Scope, and Unavoidable Conflicts of Interest*, 2004 ECON. REV., no. 4, 2006 at 23, 26, available at http://www.frbatlanta.org/filelegacydocs/erq404_sirri.pdf (“What is clear is that the scope economies that arise from housing the customary business lines of investment banks under one roof lead to clear conflicts of interest.”).

152. See, e.g., Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 REV. FIN. STUD. 653, 653 (1999) (concluding that the recommendations by underwriter analysts show significant evidence of bias that the market does not fully recognize and positing on this basis a potential conflict of interest inherent in the different functions that investment bankers perform); Kent L. Womack, *Do Brokerage Analysts' Recommendations Have Investment Value?*, 51 J. FIN. 137, 139 (1996) (showing that the new buy and sell recommendations of stocks by security analysts at major U.S. brokerages display significant, systematic discrepancies between prerecommendation prices and eventual values); cf. Jonathan Clarke et al., *Are Analyst Recommendations Biased? Evidence from Corporate Bankruptcies*, 41 J. FIN. & QUANTITATIVE ANALYSIS 169, 172–73 (2006) (failing to find overoptimism in analyst recommendations, including those of affiliated analysts, and concluding that recently passed legislation to reduce analysts' conflicts of interest might be an overreaction).

153. Sirri, *supra* note 151, at 29. The analyst might favor some investors over others in choosing how to disseminate the research; for example, if the research information arose because of some corporate finance performed by the analyst, the analyst might be tempted to pass that information along to a favored trading client. *Id.* The analyst could also allow the information to be used internally at the bank's proprietary trading desk, with the bank establishing a large principal position based on this inside information. *Id.*

154. To the extent that a portfolio adviser is permitted to use client brokerage commissions on behalf of its clients, the adviser might try to obtain products or services—most notably, research—from a broker-dealer in exchange for the direction of client-brokerage transactions to that same broker-dealer, creating a potential conflict of interest insofar as a portfolio adviser could then use the commissions to acquire goods, services, or both, which benefits itself rather than the funds under management.

155. Front-running is the illegal practice of a broker's executing orders on a security for its own account in advance of filling orders previously submitted by its customers in an attempt to benefit from the resulting changes in prices affected by the customer orders.

be proscribed outright surely warrants far greater regulatory scrutiny than is presently the case.¹⁵⁶

Although it is, of course, possible to address this problem by simply banning self-dealing transactions between a bank's sales desks and its trading desks, this will very likely entail substantial monitoring costs as regulators strive vainly to police the behavior of those who are under very real pressures not just to make a market but to make a market unduly stacked in their favor. On the other hand, the problem could be resolved by simply proscribing proprietary trading by a bank in securities issued/underwritten by that same bank. But this ignores the important fact that investors generally expect an investment bank to make a market in the securities that it issues/underwrites. Where to draw the line then? How much proprietary trading is too much? The private partnership provides an answer in pulling off—perhaps uniquely so—what is, in our view, the very difficult balancing act of finding just the right subtle compromise between engaging in market-making activities, on the one hand, but also, on the other hand, not allowing these activities to become such a significant part of the business that the temptation to subjugate the client's best interests to those of the firm's proprietary account becomes simply too great to be ignored.

To amplify this delicate balancing act, recall the distinction between selling in a primary market versus selling in a secondary market—a distinction that, of course, is embodied in the very structure of the original security regulation statutes. In a primary market, issuers sell securities that they have designed and structured—often with the help of a consortium of underwriters—to a variety of different investor-clients. The conceptual move we advocate for is that the investor-clients involved in these primary sale transactions involving difficult-to-price financial securities be deemed clients to whom some kind of fiduciary duty or obligation is owed—a duty, so we argue, that must not be diluted or attenuated by conflicting fiduciary duties and obligations owed to public shareholders.¹⁵⁷

156. See, e.g., *Sales and Trading*, MORGAN STANLEY, <http://www.morganstanley.com/institutional/sales/index.html> (last visited Aug. 23, 2011) (listing sales and trading as one of its primary institutional services).

157. Interestingly, this very idea was the subject of a highly charged debate in the critical first years after the Exchange Act was passed. See, e.g., John T. Flynn, *Other People's Money: Contradictory Recommendations of the SEC—Are Brokers and Traders To Be Separated? Let the SEC Protect the Public*, NEW REPUBLIC, Jan. 8, 1936, at 253, 253. An early draft of the Exchange Act would have prohibited a broker from acting as a

In particular, where an issuer/underwriter of securities operates within a public corporation, the issuer/underwriter must balance the interests of clients with the various fiduciary duties owed to the shareholders of the corporation.¹⁵⁸ To the extent that compensation is linked to share price or to the value of the trading book or to some combination of both, the investment banker, working as a shareholder-employee within a publicly traded investment bank, is thus additionally tempted to evaluate any given decision not in terms of the best interests of the client-customer to whom the banker does not owe a fiduciary duty but rather in terms of its impact upon the trading book or upon the stock price of the firm more generally. Indeed, albeit purely anecdotal, evidence of such bias can be routinely confirmed in casual discussions with those who are working, or who have worked, in the securities-selling industry.¹⁵⁹

The story of *Goldman Sachs v. SEC* is instructive in this regard.¹⁶⁰ The case centers on allegedly materially misleading statements and omissions made in connection with a synthetic CDO Goldman Sachs structured and marketed to investors. This synthetic CDO, known as ABACUS, was tied to the performance of subprime MBS. Goldman Sachs's marketing materials represented that the reference portfolio was selected by an independent "collateral manager," ACA. "Undisclosed in the marketing materials, [however,] and unbeknownst to investors, a large hedge fund, Paulson & Co. (Paulson), with economic interests directly adverse to investors in ABACUS[], played a significant role in the portfolio selection process."¹⁶¹ Indeed, "after participating in the selection of the reference portfolio, Paulson effectively shorted the

dealer or underwriter—the rationale taking into account the inherent conflicts of interest present where persons acting as agents for their customers enter the market and trade on their own behalf. See National Securities Exchange Act of 1934, H.R. 7852, 73d Cong. § 10 (1934); National Securities Exchange Act of 1934, S. 2693, 73d Cong. § 10 (1934).

158. See generally ROBERT CHARLES CLARK, CORPORATE LAW (1986) (describing at length the duties of officers and directors).

159. See generally MICHAEL LEWIS, LIAR'S POKER: RISING THROUGH THE WRECKAGE ON WALL STREET (1989). Lewis suggests that the *culture* of Salomon Brothers was one in which customers consistently took a back seat to the firm's own trading book. See *id.* at 208. When Lewis, for example, had unknowingly relieved a losing long position on Salomon's own trading book to the detriment of a small institutional client, he wrote that the best thing for him to do was to "pretend . . . that [he] had meant to screw the customer. People would respect that. That was called *jamming*." *Id.* at 208 (emphasis added). In response to the question of how this systematic practice of harming the customer did not lead to financial ruin, Lewis offered up as an answer the following comment by the head of the corporate bond desk at the time, Tom Strauss, unbelievably made while at a lunch with a customer: "Customers have very short memories." *Id.* (internal quotation marks omitted). Jamming a client is now called "ripping his face off." See FRANK PARTNOY, F.I.A.S.C.O.: THE INSIDE STORY OF A WALL STREET TRADER 61 (1999).

160. See generally Complaint, SEC v. Goldman Sachs & Co., No. 1:10-cv-03229, 2011 WL 2305988 (S.D.N.Y. June 10, 2011), 2010 WL 1508202.

161. *Id.* at 2.

[MBS portfolio it helped select by entering into credit default swaps” with Goldman to buy protection on specific layers of the ABACUS capital structure.¹⁶²

Given its short position, Paulson had an economic incentive to choose a list of MBS that it expected to experience credit events in the near term.¹⁶³ Goldman Sachs did not disclose Paulson’s adverse economic interests or its role in the portfolio selection process.¹⁶⁴ In other words, Goldman arranged a transaction at Paulson’s request in which Paulson heavily influenced the selection of the portfolio to suit its economic interests but failed to disclose to investors Paulson’s role in the portfolio selection process or its plainly adverse economic interests more generally.¹⁶⁵ On the contrary, Goldman misled ACA into believing that Paulson had invested approximately \$200 million in the equity tranche of ABACUS.¹⁶⁶ Less than one year later, 99% of the portfolio had been downgraded,¹⁶⁷ with investors losing over \$1 billion in total. Paulson’s opposite CDS positions, on the other hand, netted a profit of close to \$1 billion.

The facts could have been worse for Goldman Sachs. To be fair, it was Paulson, and not Goldman, that directly profited on the short position, though Goldman presumably earned its fair share in fees; indeed, Goldman claims to have lost roughly \$100 million on the trade.¹⁶⁸ But regardless of the precise economics of the ABACUS transaction, more generally speaking, the problem arises in this context

162. *Id.*

163. *Id.*

164. *Id.*

165. *Id.*

166. The “equity tranche” exists at the bottom of the CDO structure. In particular, it is the first layer to experience losses when the performance of the MBS portfolio that comprises the CDO deteriorates. Investors in the equity tranche therefore have a strong economic incentive to see the reference MBS portfolio succeed. *Id.* at 13.

167. Somewhat damningly, perhaps, the credit ratings of the Class A-D tranches of ABACUS ranged from A2/A to Aaa/AAA, respectively, where note that a four-year idealized default probability—assuming 50% average expected loss-given-default—for the lowest A2 rating would be calculated by Moody’s as approximately equal to 0.3796%. See ARTURO CIFUENTES, MOODY’S INVESTOR’S SERV., THE BINOMIAL EXPANSION METHOD APPLIED TO CBO/CLO ANALYSIS 2–4 (1996), available at http://www.statebrand.ru/upload/files/lib_1223663480.pdf; GOLDMAN SACHS, ABACUS 2007-AC1: \$2 BILLION SYNTHETIC CDO REFERENCING A STATIC RMBS PORTFOLIO 14 (2007), available at <http://blogs.reuters.com/felix-salmon/files/2010/04/30036962-Abacus-2007-Ac1-Flipbook-20070226.pdf>.

168. See Louise Story, *Bank Says Losses Prove No Ill Intent*, N.Y. TIMES, Apr. 21, 2010, at B1.

not so much from the fact that a Goldman Sachs is at the same time betting against a mortgage-linked CDO that it has sold to its investor-clients per se but rather because a Goldman Sachs has assumed a short position with respect to a product that it has sold to investors not in its capacity as a broker-dealer operating in a secondary market but rather in its capacity *as an issuer/underwriter operating in a primary market*.¹⁶⁹ That is, in ways that broker-dealers just simply do not, issuers/underwriters of difficult-to-price securities owe a special fiduciary-like duty to the general investing public.¹⁷⁰

They must. For as the facts of *Goldman Sachs* aptly illustrate, the temptation for mischief is just too great otherwise. It is just too easy to imagine how banks might profit from selling to investor-clients difficult-to-price securities that are from the very start—as was the ABACUS CDO, perhaps—“structured to fail” or “intended to fail.”¹⁷¹ This conflict of interest between shareholder and client, between what is best for the firm’s proprietary account, on the one hand, and what is best for the client’s nonproprietary account, on the other, is entirely unacceptable. The duty or obligation to act in the client’s best interest must not be subjugated to management, the board of directors, or the shareholders more generally.¹⁷² In transacting with an investment bank,

169. Technically speaking, the issuer was ABACUS 2007-AC1, Ltd., incorporated with limited liability in the Cayman Islands, the co-issuer was ABACUS 2007-AC1, Inc., a corporation organized under the laws of the State of Delaware, and the initial purchaser/underwriter was Goldman, Sachs & Co. See GOLDMAN SACHS, *supra* note 167, at 19. These legalistic distinctions are not meaningful, in our view, as to whether Goldman can be properly conceptualized as the issuer/underwriter of ABACUS.

170. A similar question was addressed in a recent decision in the Federal Court of Australia. See *ASIC v. Citigroup Global Mkts. Austl. Pty. Ltd. (No. 4)* (2007) 160 FCR 35 (Austl.). The private side of Citigroup acted for Toll Group on a proposed takeover of Patrick Corporation, while at the same time, the public side of Citigroup—proprietary traders—purchased a significant parcel of shares in Patrick. *Id.* at 43. The argument advanced by Australia’s financial services regulator, ASIC, was that proprietary trading in the target company’s shares in the lead up to the takeover—by a division of the bank separate from the advisory team—placed the bank in a situation where its personal interests conflicted with its duty to the bidder-client, in breach of a fiduciary duty owed by the bank to that client. *Id.* Interestingly, Judge Jacobson concluded that “[b]ut for the express terms of the mandate letter, the pre-contract dealings between Citigroup and Toll would have pointed strongly toward the existence of a fiduciary relationship in Citigroup’s role as an adviser,” noting that “[v]ulnerability of the client is one of the indicia of the fiduciary relationship,” where that vulnerability should be judged not by reference to the sophistication of the client but rather with regards to the “special opportunity of the adviser to abuse the expectation of loyalty.” *Id.* at 78, 83.

171. The idea here is that an entrepreneur typically does not seek to raise significant amounts of capital in order to start a company only so that the entrepreneur might make corresponding bets that the company will fail. Whether an issuer/underwriter might structure and market a CDO for that sole purpose, however, is an entirely different matter.

172. Along exactly these lines, ASIC alleged that Citigroup’s proprietary trading gave rise to five separate conflicts of interest. *ASIC*, 160 FCR at 87–92. The first three

an investor must not be asked to determine whether the principal benefits of a particular financial product—a product that they do not altogether understand by assumption—inure to them or to the shareholders or to the twenty-something-year-old sitting essentially unsupervised at a fixed income proprietary trading desk.

This claim that proprietary trading on the contributed equity capital of public shareholders is wholly incompatible with the sale of difficult-to-price securities on the primary market flows from the recognition that primary markets are of primary importance. It is the point at which these financial instruments capable of causing such sweeping havoc for society more broadly first enter the financial system, and as a result, these gates need to be watched very carefully—and for the last eighty years, they have, at least in the case of easy-to-price securities, such as equities or U.S. Treasuries. But where securities are sold that cannot be accurately priced because the relevant markets are illiquid and because the technical and logistical complexities far exceed whatever could have possibly been imagined by the original drafters of the securities laws, the disclosure model, as evidenced by recent events, has proven far less successful.¹⁷³ In effect, investors have been left to purchase securities at their own peril, with disclosure no longer serving the purpose of caveat

allegations rested upon the argument that as a fiduciary Citigroup had a positive duty to disclose to Toll all information in its possession that might be relevant to the relationship and the advice provided under it. *Id.* at 88–90. Judge Jacobson rejected—implicitly, if not explicitly—the existence of such a duty. *Id.* As for the fourth claim, ASIC alleged that it was in Toll’s best interest that the price of Patrick shares not increase because this would lead to an erosion of the apparent premium being offered by Toll over the prebid market price of Patrick shares, where Citigroup’s proprietary trading had a contrary long position in Patrick shares. *Id.* at 90–92. Jacobson rejected the claim on a factual level, concluding that ASIC failed to establish that Toll had the interest alleged—even though all sorts of other reasons exist why Toll would not want the price of Patrick shares to increase; for example, it may increase the likelihood that the bid is rejected or later challenged on legal grounds as unfair. *Id.* at 91. Finally, with respect to members of Citigroup’s senior management and compliance teams who had become aware of its substantial proprietary shareholding, Judge Jacobson again found no conflict because, in his view, there was no evidence to support the allegation that there was a risk that the views of senior management on the bid price would be sought by Toll, even though it does seem hard to believe that *at the time* there really was no risk at all that Toll would contact senior management or compliance teams in connection with what was an ostensibly significant business matter. *Id.* at 92.

173. The following crises are examples of this: the 1989 S&L crisis, the 1994 bond market crisis, the 1995 Mexican debt crisis, the 1996–1997 Asian crisis, the 1998 Russian collapse and the long-term capital management debacle, the 2008 subprime mortgage crisis, the 2010 European sovereign debt crisis, and potentially the 2012 corporate debt crisis.

vendor because investors no longer understand the full import of the disclosures being made. Moreover, hopelessly conflicted banks have been able to rationalize selling to clients investment strategies that they know or strongly suspect are fundamentally flawed by claiming that their clients knew full well what they were getting themselves into, that on the basis of the public disclosures made, these clients voluntarily chose to purchase the offered securities having arrived—for whatever reasons—at very different conclusions than the banks did as to their prospective long-term profitability.

And so, where the disclosure model is not working, other measures and steps must be taken. It is not enough to blandly blame investors for failing to understand public disclosures of complex-structured financial products for which there is no active market; indeed, to do so is to effectively transform the operative standard from caveat vendor back to caveat emptor—the very standard that the original securities statutes sought to eliminate and replace.¹⁷⁴ No, the focus must turn to the “sell side” and, in particular, to implementing modifications to the existing market structure that more forcefully incentivize issuers/underwriters to fully understand the products that they are selling to investors on the primary market and to better value them accordingly, both in terms of ask prices and mark-to-model valuations to the extent that these assets are required to remain on their balance sheets. The proposal set forth represents a humble, tentative step in that direction.

C. The Regulatory Carrot

It is important to understand that our proposal does not envision an absolute bar on public ownership of investment banks. If an investment bank wishes to structure itself as such, then of course it should be perfectly free to do so. But given this, the real problem in implementing the proposed framework then lies with the competition for individual talent arising from those firms that choose to publicly incorporate and from competitors flush with low-cost capital—and less burdened by the

174. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972) (“A fundamental purpose [common to the security laws was] to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.” (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963))); see also H.R. REP. NO. 73-85, at 2 (1933) (“Let the seller also beware.”), quoted in *Wilko v. Swan*, 346 U.S. 427 (1953). It was premised on the theory that complete and timely availability of information would result in efficient, well-functioning capital markets. See, e.g., *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 357 (2d Cir. 1973) (holding that “[t]he securities laws seek to prevent restrictions” on flows of information and funds that would “distort the market’s estimate of value”).

nuisance of long-term thinking—that are in a prime position to lure away productive partners with enticements of substantial salary and signing bonuses. In other words, in terms of the two main capital inputs identified above, it is not the higher cost of capital that presents a problem—as is typically suggested—so much as it is the retention of human capital and in particular the deterioration of the binding of human capital to the firm, via plowback provisions and book value accounting, which takes place where lucrative outside offers are outstanding.¹⁷⁵

In Part III.C.1–2, we provide a brief sketch of a proposed regulatory framework that is designed to give those willing to structure themselves as private partnerships a chance to compete in the highly competitive marketplace for the human capital of investment professionals. In particular, we isolate two principal regulatory tools that may be employed to entice investment banks to voluntarily arrange themselves as private partnerships: (1) mandatory periodic disclosures and (2) the imposition of fiduciary duties and obligations owed to investors.¹⁷⁶

1. Varying Mandatory Periodic Disclosures

The strategies employed by proprietary traders are very often valuable, highly confidential trade secrets. This fact alone makes disclosure more burdensome than would typically be the case for the general public corporation. By suitably ramping up the scope and breadth of disclosure requirements for public corporations relative to private partnerships, the latter form obviously becomes more attractive accordingly—especially for those trading firms at the very forefront of financial innovation.

175. “Even Goldman Sachs, which had a long-standing policy of not making lateral hires from other firms, began to do so in 1990 to stem the outflow of human capital even while it remained a private partnership.” Lehmann, *supra* note 111, at 84.

176. There is a third potential regulatory tool: risk controls in the form of restrictions on position sizes, short sales, and leverage. The focus of the present Article is SEC rulemaking. We do not feel that this type of regulatory action is well suited for the SEC. See, e.g., Alternative Net Capital Requirements for Broker-Dealers that Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428 (June 21, 2004) (to be codified at 17 C.F.R. pts. 200 & 240) (resulting in all five major investment banks’ *increasing* their overall leverage in taking on ever larger and more risky positions). The disastrous consequences of this particular excursion into setting net capital requirements for various financial entities was, in part, to be sure, a matter of regulatory will, but it was also, in larger part, we believe, a matter of regulatory competence. What institutional entity should then properly take hold of these regulatory reins becomes a very interesting question, but one unfortunately that also takes us beyond the scope of the present Article.

Moreover, because proprietary trading firms routinely use short sales and leverage and their assets are typically illiquid, mark-to-market accounting presents a host of significant problems for firms engaged in proprietary trading.¹⁷⁷ To wit, on September 30, 2008, the SEC and the Financial Accounting Standards Board (FASB) issued a joint clarification regarding the implementation of fair-value accounting rules in cases where a market is disorderly or inactive.¹⁷⁸ This guidance clarified that forced liquidations are not indicative of fair value because this is not an “orderly” transaction as that term is used in Financial Accounting Standard (FAS) 157.¹⁷⁹ Furthermore, it clarified that estimates of fair value can be made using the expected cash flows from such instruments, provided that the estimates reflect adjustments that a potential buyer would willingly make, such as adjustments for default, liquidity, and interest rate risks.¹⁸⁰ These rules would of course continue to apply to

177. Former Federal Deposit Insurance Corporation Chair William Isaac, for example, placed much of the blame for the subprime mortgage crisis on the SEC and its fair value rules, especially the requirement that banks mark their assets to market, particularly with respect to MBS. See Brooke Sopelsa, *Former FDIC Chair Blames SEC for Credit Crunch*, CNBC (Oct. 9, 2008, 12:49 PM ET), http://www.cnbc.com/id/27100454/Former_FDIC_Chair_Blames_SEC_for_Credit_Crunch. The intent of a mark-to-market accounting standard is to help investors understand the value of these assets at any given point in time rather than just their historical purchase price. Where the market for these assets is distressed, however, it is difficult to sell at prices that reflect the value of the mortgage cash flows. As initially interpreted by companies and their auditors, the lower actual sale value, and not the higher implied cash flow value, was used as the market value, causing many large financial institutions to recognize significant losses during 2007 and 2008, triggering margin calls, and often resulting in further forced sales and emergency efforts to obtain cash to pay off the next set of margin calls. Markdowns also reduced the value of bank regulatory capital, requiring additional capital raising efforts and creating uncertainty as to the overall health and long-term sustainability of the bank. If cash flow-derived value—which excludes market judgments as to default risk but may also more accurately reflect actual value if the market is sufficiently distressed—had been used, the size of these problematic market value adjustments under the accounting standard would have been significantly reduced. *But see* Floyd Norris, *Problem for Bankers? The Rules*, N.Y. TIMES, Mar. 13, 2009, at B1 (arguing angrily that blaming the accounting rules is akin to saying, “If only the banks could pretend the assets were valuable, then the system would be safe”).

178. See Press Release, Sec. and Exch. Comm’n & Fin. Accounting Standards Bd. Staff, Clarifications on Fair Value Accounting (Sept. 30, 2008) (on file with the Securities and Exchange Commission), available at <http://www.iasplus.com/usa/sec/0809fairvalue.pdf>; see also Emergency Economic Stabilization Act of 2008, H.R. 1424, 110th Cong. § 132 (2008) (restating the SEC’s authority to suspend application of FAS 157 if the SEC determines it is in the public’s interest and protects investors).

179. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 157: FAIR VALUE MEASUREMENTS 7 (2008) [hereinafter FAS 157], available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs &blobkey=id&blobwhere=1175820931833&blobheader=application%2Fpdf>.

180. See *id.* at 21. On April 9, 2009, FASB did finally issue its official update to FAS 157, easing the mark-to-market accounting rules that apply where the market is unsteady or inactive. See *Status of FASB Staff Position 157-4*, FIN. ACCOUNTING STANDARDS

private partnerships, but again, so as to level the playing field, the idea is that they would not apply, or apply with lesser force, to public corporations, where we should recall that the theoretical motivation for doing so is that these firms are less capable of independently generating accurate valuations of difficult-to-price securities and therefore are more in need of the harsh discipline of unfettered capital markets.

Finally, proprietary trading strategies are often so dynamic that regulatory snapshots, such as quarterly 10-Q reports, paint an unreliable picture of recent history in terms of the relevant risk, return, and leverage characteristics of the firm. Long positions can very quickly become short positions, and leverage often changes by an order of magnitude so fast that the true value of periodic reporting becomes a bit unclear.¹⁸¹ Understanding that disclosure in this context will always be ineffectual to a certain extent, the frequency of such disclosures by publicly listed companies can nevertheless be increased so as to raise the relative expense of incorporation, where it is not so much the increase in terms of the actual costs of making such disclosures—application fees and legal expenses—that is important as it is the increase in exposure to legal liability for fraudulent statements made in connection with these now more frequently filed, government-mandated disclosures—disclosures that are backed by the possibility of criminal sanctions and often highly publicized SEC enforcement.¹⁸²

The argument that will predictably be made against increasing the disclosure obligations of a public corporation as proposed is that the underlying economics of proprietary trading is such that the added regulatory burden will likely push proprietary traders into other organizational forms that are less economically efficient or into foreign jurisdictions that are less mindful of the need for securities regulation in general. Although the overall impact of interjurisdictional competition

BD. (Apr. 9, 2009), http://www.fasb.org/cs/ContentServer?c=Pronouncement_C&pagename=FASB%2FPronouncement_C%2FStatusPage&cid=1176154735524.

181. See COHAN, *supra* note 144, at 75 (reporting that at the end, Bear Stearns's leverage ratio was 50:1 during the quarter, with it taking the steps necessary at the end of the quarter to bring the ratio back down to approximately 30:1).

182. For an interesting discussion of such matters, see Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237 (2009), which explores a system of civil liability for mandatory securities disclosure violations by established publicly traded issuers wherein officers and directors would be subject to measured liability, with damages payable to the issuer.

is not altogether clear,¹⁸³ and the moral force of an argument that essentially relies on the dictum “if you can’t beat ‘em, join ‘em” in calling for inaction is dubious at best, that other organizational forms will be adopted in response to this proposal is precisely the point. Private partnerships are inefficient only according to one very narrow definition of that term. As we have seen, several important societal benefits associated with having investment banks structured as private partnerships exist—including, for example, the resurrection of the importance of client relationships—that are seldom, if ever, fully internalized by those making the decision to incorporate in the first place because those individuals, all too often it appears, are more eager to cash out quickly than to think through all the long-term ramifications of their decisions not just for finance but for society more generally.¹⁸⁴

2. *Varying the Fiduciary Duties and Obligations Owed to Investors*

In addition to varying mandatory disclosure requirements according to adopted ownership structures, the choice of the private partnership structure can be similarly encouraged by varying the legal obligations or duties owed to investors. In particular, as an investor and an investment bank hold an increasing proportion of the same assets on their respective balance sheets, the bank, generally speaking, on some level becomes less a fiduciary vis-à-vis the investor and more an investment partner of sorts. The applicable standard of care should reflect this important fact. That is, the greater the extent to which the firm has also invested in the same financial products sold to its investor-clients, the lower, correspondingly, should be its exposure to legal liability arising out of disclosures made in connection with these products; for instance, if a

183. Compare Richard B. Stewart, *Pyramids of Sacrifice? Problems of Federalism in Mandating State Implementation of National Environment Policy*, 86 YALE L.J. 1196, 1196–97 (1977) (discussing the difficulties the federal government, courts, and states face in enforcing federal statutes), and Richard B. Stewart, *The Development of Administrative and Quasi-Constitutional Law in Judicial Review of Environmental Decisionmaking: Lessons from the Clean Air Act*, 62 IOWA L. REV. 713, 728, 736 (1977) (discussing judicial review of the administrative action), with Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the “Race-to-the-Bottom” Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1210–13 (1992) (discussing the “race-to-the-bottom” effect in environmental regulation that results from interjurisdictional competition), and Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361–63 (1998) (arguing for more competition facilitated by a less restrictive basis for allocating regulatory jurisdiction in the context of securities law). See also Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 908 (1998) (discussing the race-to-the-bottom and “race-to-the-top” effect with regard to regulatory competition among countries).

184. See ENDLICH, *supra* note 129, at 8, 17–18.

bank has invested more than 50% of its balance sheet in a CDO in which it has also encouraged clients to invest, should the standard of care relating to such actions undertaken or disclosures made to the client by the bank in connection with the CDO really be as great as if the bank had invested, say, only 5%?

The precise tradeoff between the standard of care and the equity stake assumed is, of course, an empirical or political question. The important point here is only that the exposure to liability should be made to decrease in proportion to the equity stake assumed in the investment products marketed and sold to investors, and that the slope of the negative relationship should be sufficiently steep so as to effectively induce investment banks to adopt ownership structures that better align their incentives with those of their clients.¹⁸⁵ The implicit assumption being made here, of course, is that a bank organized as a private partnership is more likely to hold the same assets as its clients than is a similarly situated publicly traded corporation. To the extent that this holds true, there then exists a cogent theoretical basis for having the standard of care owed by investment banks, structured as private partnerships, be lower than the corresponding standard for equivalently positioned public corporations because investors need not repose nearly the same measure of trust and confidence in those with whom their financial prospects are closely aligned as they must in those with whom their financial prospects are not so closely aligned.¹⁸⁶

185. The tort of negligent misrepresentation, for example, could be made an unavailable cause of action where investors have voluntarily assumed a significant equity stake in the recommended portfolio. See RESTATEMENT (SECOND) OF TORTS § 552 (1977) (stating the essential elements). That is, by virtue of this equity stake, arbitrageurs are believed to be sufficiently motivated to understand their own trading strategies, and it is therefore less important that communications made in connection with these strategies take place in the shadow of the civil tort of negligent misrepresentation.

186. The reader may have noted the following tension in this approach. Consider the case *Kimmell v. Schaefer*, 675 N.E.2d 450 (N.Y. 1996). The New York Court of Appeals emphasized the importance of a “special relationship,” which it interpreted as functioning in much the same way as pecuniary interest, in its articulation of its three-factor test to determine whether sufficient contact exists for the tort of negligent misrepresentation to attach. *Id.* at 454. Within our framework, this inquiry is important only insofar as it serves to clarify whether the relevant financial actor is better characterized as an investment adviser or as a broker-dealer, a determination that we believe, as will be discussed later, ought to be guided by bright-line rulemaking. Once this determination is made, however, that is, once the special relationship exists, under the preceding approach, the analysis *then*—and only then—chases after the wrong suspect in that problems lie less with the investment adviser who chooses to go “all in” with the client and more with the investment adviser who has no such pecuniary interest in, or bears no such special

IV. BROKER-DEALERS AND INVESTMENT ADVISERS

This Part hopes to achieve two distinct objectives: (1) to set forth what should be the relevant duties owed to investors by investment advisers and broker-dealers, respectively, and (2) to argue that the broad condemnation of proprietary transactions, as exhibited by the reform proposals surveyed in Part I, is misplaced insofar as it applies specifically to investment advisers and broker-dealers.

A. The Fiduciary Responsibilities of Broker-Dealers and Investment Advisers

This Part describes the applicable duties and obligations that should be owed to investors by (1) investment advisers and (2) broker-dealers.

1. Strengthening the Fiduciary Responsibilities of Investment Advisers

Under the proposed framework, investment advisers would retain the same fiduciary duties as implied under the Advisers Act and its subsequent interpretations by the courts,¹⁸⁷ where recall that section 206 of the Advisers Act is the source of this federal fiduciary duty.¹⁸⁸ Interestingly, section 206 does not mention fiduciary duties; it states only that it is unlawful for investment advisers “to employ any device, scheme, or artifice” or “to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.”¹⁸⁹ It was not until the Supreme Court interpreted the Advisers Act in *SEC v. Capital Gains* that the concept of fiduciary duty was

relationship to, the transaction at issue and whose incentives are consequently likely not as well aligned with those of the client.

187. Although not specifically addressed in the present Article, we would, of course, additionally advocate for strengthening the requirements for registration as an investment adviser by, for example, including bank-holding companies within the section 202 statutory definition (15 U.S.C. § 80b-2 (2006)); lowering the section 203(b)(3) fifteen-client threshold (15 U.S.C. § 80b-3 (2006)); decreasing the section 203(a)(1)(A) \$25-million-assets-under-management threshold (15 U.S.C. § 80b-3a (2006)); or doing all three of these.

188. See Investment Advisers Act of 1940, ch. 686, § 206, 54 Stat. 847, 852 (current version at 15 U.S.C. § 80b-6 (2006)).

189. *Id.* Section 206(3) does prohibit any registered investment adviser from engaging in or effecting a transaction on behalf of a client while acting either as principal for its own account or as broker for a person other than the client, without disclosing in writing to the client before the completion of the transaction the adviser’s role in the transaction and obtaining the client’s consent. See *id.* Not only are we advocating for a larger set of proscribed securities transactions but we are also not allowing, in the context of difficult-to-price securities, mere disclosure and client consent to purge transactions of the taint of self-dealing.

imposed upon investment advisers.¹⁹⁰ Because the exact nature of an investment adviser's fiduciary duty was never explicitly defined, the SEC has "expansive leeway" to create or redefine what obligations are imposed.¹⁹¹ Although an adviser's general duties involve promoting the client's financial goals, the fiduciary obligations regulated most often by the SEC, however, are those negative duties aimed at protecting the best interests of investors.¹⁹²

Although the Volcker Rule, in particular, certainly hints at our regulatory appeal in prohibiting various bank entities from engaging in proprietary trading or entering into certain relationships with hedge funds and private equity funds, we advocate pushing this idea even further with respect to investment advisers, arguing that the SEC should use its expansive leeway in defining what obligations are owed to investors to extend the section 206 fiduciary duty to explicitly include the restrictions set forth in sections 10(f) and 12(d)(3) of the Investment Company Act of 1940.¹⁹³

a. Expanding the Section 206 Fiduciary Duty To Explicitly Preclude Certain Affiliations with Securities-Related Businesses

Section 10(f) of the Investment Company Act prohibits a fund from purchasing any security during an underwriting or selling syndicate if the fund has certain affiliated relationships with a principal underwriter for the security.¹⁹⁴ The section is designed to protect fund-shareholders by preventing an affiliated underwriter from placing or "dumping" unmarketable securities with the fund during a primary offering. Note

190. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (explaining only that other courts have generally defined a fiduciary duty as "an affirmative duty of 'utmost good faith and full and fair disclosure of all material facts' as well as an affirmative obligation 'to employ reasonable care to avoid misleading'" (quoting WILLIAM L. PROSSER, *THE HANDBOOK OF THE LAW OF TORTS* 535 (2d ed. 1955); 1 FOWLER V. HARPER & FLEMING JAMES, JR., *THE LAW OF TORTS* 541 (1956))).

191. See Thomas P. Lemke & Steven W. Stone, *The Madoff "Opportunity": Harmonizing the Overarching Standard of Care for Financial Professionals Who Give Investment Advice*, *WALL ST. LAW.*, June 2009, at 1, 5.

192. See *Capital Gains*, 375 U.S. at 191–92 (explaining that the rationale for finding a fiduciary duty requirement in the Advisers Act was congressional intent to protect investors from investment advisers who "render advice which was not disinterested").

193. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64 (2006)).

194. See 15 U.S.C. § 80a-10(f).

that where a fund has multiple subadvisers, however,¹⁹⁵ section 10(f) can work to significantly limit the fund's ability to purchase securities in a primary offering¹⁹⁶ because a fund is subject to the prohibition in section 10(f) if *any* of its advisers or subadvisers participated in the underwriting or selling syndicate—or are affiliated persons of such participants—regardless of whether or not the adviser or subadviser who recommended the purchase was an actual participant in the syndicate.¹⁹⁷ To reduce the perceived undue restrictiveness of section 10(f), in 2003 the SEC adopted as a final rule proposed amendments to Rule 10f-3,¹⁹⁸ which deemed each “series of a series company” and the “managed portions” of a fund portfolio to be separate registered investment companies for purposes of section 10(f) and Rule 10f-3.¹⁹⁹ As a result, a fund, in theory, is subject to the section 10(f) limitation only where the adviser recommending the transaction or its affiliated person is actually a participant in the transaction and is thus in a position to take advantage of the fund.

Similarly, section 12(d)(3) of the Investment Company Act generally prohibits funds and companies controlled by funds from purchasing securities issued by a registered investment adviser, broker-dealer, or underwriter in securities-related businesses.²⁰⁰ Rule 12d3-1 permits a

195. Many funds use “subadvisers” to help manage its assets. A subadviser is an investment adviser for purposes of the Advisers Act, which describes an investment adviser as a person who regularly furnishes advice to the fund with respect to the desirability of investing in, purchasing, or selling securities or other property, or is empowered to determine what securities or other property are to be purchased or sold by the fund. *See* 15 U.S.C. § 80a-2(a)(20).

196. Rule 10f-3 does provide an exemption from the prohibition in section 10(f) if certain conditions are satisfied; in particular, Rule 10f-3 permits a fund to purchase securities in a transaction that otherwise would violate section 10(f) if, among other things: (1) the securities are either registered under the Securities Act of 1933 under 15 U.S.C. § 77a-aa, part of an issue of government securities, municipal securities with certain credit ratings, or offered in certain foreign or private institutional offerings; (2) the offering involves a “firm commitment” underwriting; (3) the fund—together with other funds advised by the same investment adviser—purchases no more than 25% of the offering; (4) the fund purchases the securities from a member of the syndicate other than its affiliated underwriter; (5) the fund's directors have approved procedures for purchases under the rule and regularly review the purchases to determine whether they have complied with the procedures. *See* 17 C.F.R. § 270.10f-3(a)–(c) (2010).

197. *See* 15 U.S.C. § 80a-2(a)(3) (defining the term *affiliated persons*).

198. *See* Transactions of Investment Companies with Portfolio and Subadviser Affiliates, Investment Company Act Release No. 25,888, [2002–2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,815 (Jan. 14, 2003) [hereinafter 2003 Adopting Release] (adopting Rule 17a-10 and amending Rules 10f-3, 12d3-1, 17a-6, 17d-1, and 17e-1).

199. *See* 17 C.F.R. § 270.10f-3(a)(5)–(6) (defining the terms *managed portion* and *series of a series company*); *id.* § 270.10f-3(b) (deeming the series of a series company and managed portions of an investment company to be separate investment companies for purposes of section 10(f) and Rule 10f-3).

200. *See* 15 U.S.C. § 80a-12(d)(3) (2006). With minor exceptions, section 12(d)(3) prohibits a fund from purchasing or otherwise acquiring “any security issued by or

fund to invest up to 5% of its assets in securities of an issuer deriving more than 15% of its gross revenues from securities-related businesses.²⁰¹ Pursuant to the same 2003 Adopting Release, the SEC amended Rule 12d3-1 to permit a fund to purchase securities issued by its subadvisers—or affiliated persons of its subadvisers—in circumstances as determined by the SEC in which, again, in theory, the subadviser would have little, if any, ability to take advantage of the fund because the subadviser would not be in a position to direct the fund's securities purchases.²⁰²

Observe that sections 10(f) and 12(d)(3) reflect the same concern, as expressed in Part III, with protecting the integrity of the primary markets. There, recall that the focus was on investment banks that issue or underwrite difficult-to-price securities and the recognition that disclosure under these circumstances tends to be ineffectual, thereby transforming the operating standard from caveat venditor back to caveat emptor. Here, by contrast, the focus is on investment companies and the general obligations that such companies owe to their shareholder-investors when purchasing securities underwritten or issued by certain advisers/subadvisers, for instance, possibly an affiliated investment bank. Specifically, the Investment Company Act recognizes that certain important conflicts of interest might arise under the various circumstances described above and acts to restrict the extent to which such transactions may be entered into as discordant with the investment company's

any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is [] an investment adviser." *Id.*

201. See 17 C.F.R. § 270.12d3-1 (2010). Paragraph (a) of Rule 12d3-1 permits a fund to acquire any security issued by any person that, in its most recent fiscal year, derived 15% or less of its gross revenues from securities-related activities unless the fund would control such person after the acquisition. *Id.* Paragraph (b)(3) of Rule 12d3-1 permits a fund to invest up to 5% of the value of its total assets in the securities of an issuer that derives more than 15% of its gross revenues from securities-related activities. *Id.* Rule 12d3-1(d)(1) defines the term *securities-related activities* as a person's activities as a broker, a dealer, an underwriter, an investment adviser registered under the Advisers Act, or an investment adviser to a registered investment company. *Id.*

202. See 2003 Adopting Release, *supra* note 198, at 86,820. The exemption in Rule 12d3-1 would be available in circumstances identical to those in which the subadviser—or affiliated person—would be permitted by Rule 17a-10 to enter into a principal transaction with the fund; in other words, the exemption is available if (1) the subadviser is not, and is not an affiliated person of, an investment adviser who provides advice with respect to the portion of the fund that is acquiring the securities, and (2) the advisory contracts of the subadviser, and any subadviser who is advising the purchasing portion of the fund, prohibit them from consulting with each other concerning securities transactions of the fund and limit their responsibility to providing advice with respect to discrete portions of the fund's portfolio. See 17 C.F.R. § 270.12d3-1(c)(3)(i), (ii) (2010).

obligation to promote the best interests of its shareholder-investors. We would like to see the securities law do the same for registered investment advisers, irrespective of whether or not the funds that they advise are in fact registered investment companies.

*b. The Distinction Between Affiliated and Unaffiliated Entities
Must Be Drawn as Sharp and as Bright as Possible*

As one possible countervailing factor, SEC rulemaking in this area evinces a concern over access to capital markets; for example, in its recitation of the expected benefits of its new rules announced under its 2003 Adopting Release, the SEC stated that the amendments included therein would likely benefit funds, fund shareholders, and subadvisers in the form of increased capital formation by (1) broadening the investments opportunities available to such funds and (2) expanding the range of possible purchasers where a subadviser participates in an underwriting syndicate.²⁰³ To achieve these regulatory goals, however, note that the SEC was required to blur the distinction between what it means to be an affiliated as opposed to an unaffiliated adviser/subadviser.

Indeed, this is exactly the same kind of blurring that we will encounter in Part IV.A.2 in examining the legislative response to the conflicts of interest that very often arise between broker-dealers and investor-clients. There, we will see that the Investor Protection Act blurs the distinction between broker-dealers and registered investment advisers in deeming, under certain circumstances, the duties owed by broker-dealers to be equivalent to those owed by investment advisers in an effort to bring within the fold of legal liability certain conflicts of interest not captured by current statutory definitions, namely, of broker-dealers and investment advisers. Here, by contrast, the blurring occurs to remove certain transactions from out of this fold, with the 2003 Adopting Release holding certain transactions not to be true conflicts, even though the statutory definitions would suggest otherwise.

This smudging of definitions is arguably indicative of a more general tendency on the part of SEC rulemakers to accommodate, in the face of ever-expanding multinational financial conglomerates, the inevitable conflicts of interest that arise by manipulating definitions to pinpoint and isolate only those transactions of actual concern.²⁰⁴ That is, rather than

203. See 2003 Adopting Release, *supra* note 198, at 88,820.

204. Proposed Rule 202(a)(11)-1 is illustrative to that effect. The SEC deemed certain broker-dealers not to be investment advisers, using the authority granted to it under section 202(a)(11)(F), which exempts “such other persons not to be within the intent of [the enumerated exceptions], as the Commission may designate by rules and regulations or order,” to expand the exemption to broker-dealers who offer fee-based accounts

simply say that investment companies should not engage in certain securities transactions and leave it at that, an attempt is made instead to carve out some subset of transactions not properly characterized as impermissible self-dealing. In theory, there is nothing intrinsically wrong with this approach to rulemaking—if executed properly, it perhaps gets us the closest to the optimal outcome—but optimality is not such an easy goal to achieve in practice. The numerous provisions associated with narrowly tailored rulemaking of this sort, certainly at the start, will very likely be subject to various errors of overexclusivity and underexclusivity—some of which may in fact flow directly from actions undertaken by firms solely or in large part to avoid the rules’ regulatory ambit.²⁰⁵

But also, more importantly, it runs the risk of attenuating just what it means to be a fiduciary in the first instance. To be a fiduciary no longer means simply not engaging in self-dealing transactions with affiliates; it now means not engaging in self-dealing transactions with affiliates but only if states of the world *X*, *Y*, and *Z* also hold true. These regulatory qualifications introduce and amplify much-unneeded uncertainty or lack of salience as to the roles played by the various actors within the financial system. In other words, although enforcement costs may or may not

providing both advisory and brokerage services for a fixed or asset-based fee, as long as the advice is “incidental” to the brokerage services and there is an explicit statement that the account is a brokerage and not an advisory account—though, inexplicably, brokers would have been able to still call themselves “advisers.” Investment Advisers Act of 1940, ch. 686, § 202(a)(11)(F), 54 Stat. 847, 849 (current version at 15 U.S.C. § 80b-2(a)(11)(G) (2006)); see *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, 64 Fed. Reg. 61,226 (proposed Nov. 4, 1999) (to be codified at 17 C.F.R. pts. 275, 279). In *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007), the U.S. Court of Appeals for the District of Columbia vacated Rule 202(a)(11)-1, very sensibly finding that the SEC had exceeded its statutory authority in adopting the rule. The court reasoned that Congress had specifically addressed where a broker-dealer should be exempted from the requirements of the Advisers Act in the statute itself. *Id.* at 488. Because Rule 202(a)(11)-1 exempts a broader group of broker-dealers than contemplated by the statute, it hence conflicts with the expressed intent of Congress. *Id.* The court further reasoned that Congress, by use of the term *other persons* in section 202(a)(11)(F), limited the rulemaking authority of the SEC to persons providing advisory services other than broker-dealers. See *id.* at 491.

205. As the SEC itself noted, the amendments may encourage division of funds into discrete parts managed by multiple subadvisers. See 2003 Adopting Release, *supra* note 198, at 86,822 (“[A] fund that is advised by a subadviser that participates [or is affiliated with persons that participate] in underwriting syndicates may have an incentive to reorganize in order to . . . take advantage of the opportunity to purchase securities in reliance on that rule’s exemption.”).

increase with the complexity of narrowly tailored rules, there is the undoubted additional cost—one all too often overlooked or downplayed, so we argue—of, at best, increased uncertainty and, at worst, increased hostility and distrust of a financial system that is maligned not so much because the system screws investors over because investors know that the world is a hard place but rather because the system is not upfront and honest about this fact from the very start.

In short, the argument is that the costs of blurring the lines with respect to which actors are in a position per se to take advantage of a given fund exceed the costs of an overinclusive approach that simply does not allow such actors to align themselves in ways that might lead to basic, fundamental conflicts of interest, which, in this particular case, means simply not allowing investment advisers—and, *a fortiori*, investment companies—to engage in certain securities transactions, including purchasing securities from affiliated underwriters or acquiring nontrivial equity stakes in various securities-related businesses. It is admittedly a more dramatic step than any taken or contemplated by the SEC thus far. It involves telling very powerful and influential financial institutions that they are no longer allowed to organize themselves as they see best fit. It will, without doubt, result in a lot of heated and angry rhetoric about inefficiencies and economies of scale and intolerable infringements upon the freedom to contract.²⁰⁶

But all of this is to be courageously ignored. In insisting that investment advisers avoid certain securities transactions as prescribed above, the problem is cleanly solved—the conflicts of interest are immediately gone. And the only obvious cost associated with this solution is that an investment adviser can no longer be “affiliated” with certain securities-related businesses. Although SEC rulemaking, for whatever reasons, takes it as given that such corporate organizations be allowed to take place—indeed, it is the very baseline from which its rulemaking efforts appear to depart—we query whether this is in fact the right baseline and ask just how substantial a cost it really is, say, to not allow an investment bank to “affiliate” in the first instance with funds run by a registered investment adviser. This Article takes the position

206. See, e.g., Edward Wyatt & Eric Lichtblau, *A Finance Overhaul Fight Draws a Lobbying Swarm*, N.Y. TIMES, Apr. 20, 2010, at A1 (reporting that “more than 1,500 lobbyists, executives, bankers and others have made their way to the Senate committee that on Wednesday will take up legislation to rein in derivatives”); Noam Scheiber, *Head Lock: The Inside Story of How Goldman and the Banks Are Getting Clobbered on Financial Reform*, NEW REPUBLIC (Apr. 20, 2010, 12:00 AM), <http://www.tnr.com/article/economy/the-state-play-financial-regulation-edition> (reporting that “[s]ome two dozen executives from large corporations will be descending on Capitol Hill today to make the case against over-regulating derivatives”).

that the cost is minimal relative to the cost of further confusing investors about those in whom they can repose their trust and confidence and in whom they cannot.

c. The Illusory Benefits of Information Barriers

Of course, investment banks will argue that they have already, in effect, achieved this separation with the construction of “Chinese Walls” or “information barriers,”²⁰⁷ that such restrictions on the flow of information represent a less dramatic means of limiting the purported conflicts of interest.²⁰⁸ But as Martin Lipton—no great defender of the information-barriers approach to conflicts of interest²⁰⁹—keenly observed, there are two situations that do cause concern: (1) where the firm makes investment recommendations to its clients, and (2) where the firm invests for its own account.²¹⁰ In either of these two situations, at least two factors argue in favor of an absolute prohibition on investment transactions in securities as to which even an isolated department of the firm has inside information: (1) the need to conform to an investor’s reasonable expectations and (2) the very practical consideration of removing human temptation.²¹¹

207. The term *Chinese Walls* is not without its critics. See, e.g., Peat, Marwick, Mitchell & Co. v. Superior Court, 245 Cal. Rptr. 873, 887–88 (Ct. App. 1988) (Low, P.J., concurring). We opt, therefore, for the anodyne term *information barriers*.

208. See Martin Lipton & Robert B. Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459, 499 (1975) [hereinafter Lipton & Mazur, *Chinese Wall Solution*]. See generally Leonard Chazen, *Reinforcing the Chinese Wall: A Response*, 51 N.Y.U. L. REV. 552 (1976); Leo Herzel & Dale E. Colling, *The Chinese Wall and Conflict of Interest in Banks*, 34 BUS. LAW. 73 (1978); Leo Herzel & Dale E. Colling, *The Chinese Wall Revisited*, 6 CORP. L. REV. 116 (1983); Martin Lipton & Robert B. Mazur, *The Chinese Wall: A Reply to Chazen*, 51 N.Y.U. L. REV. 579 (1976).

209. At least this was the case thirty-five years ago.

210. Lipton & Mazur, *Chinese Wall Solution*, *supra* note 208, at 499. Lipton finds that “no public interest [is] to be served” in permitting own-account investments in the face of inside information. *Id.* at 501. To the extent that the proprietary traders purchase any part of the issuance, it is hard to see how an investment bank can issue/underwrite securities while at the same time engaging in proprietary trading on its own capital account. It would appear just such an impermissible own-account investment. Nevertheless, the solution adopted by today’s publicly incorporated investment banks is to implement just the very information barrier of which Lipton had this to say: “The possibility of self-interest abuse *mandates* that the [information-barriers] approach not be extended to permit a firm with departmentally isolated inside information to invest for its own account through a department that does not have the information.” *Id.* (emphasis added).

211. *Id.* at 499.

Specifically, where one department within the firm is making recommendations or rendering investment advice contrary to inside information in the possession of another isolated department, it would appear to be an arrangement that simply does not meet the reasonable expectations of investors who rely on these recommendations and whose dependence on such recommendations is essential to the continuance of public participation in the securities markets.²¹² Accordingly, “[i]t cannot, therefore, be accepted that some kind of disclosure by the broker-dealer at the commencement of the customer relationship (to the effect that because of the broker-dealer’s [information-barrier] procedures the client may in the future be the victim of a bad recommendation) would satisfy this expectation.”²¹³ Lipton confines his discussion, however, to average public investors who interact with broker-dealers offering investment advice; he is less concerned—if at all—with a firm that combines professional investment management with investment banking. We take the exact opposite position. We are much more concerned with conflicts of interest arising in connection with professional investment management than we are with those involving the average lay investor.

The distinction Lipton draws is grounded in notions of investor sophistication. Objecting to the concept that mere disclosure of a firm’s information-barrier policies is sufficient to meet the reasonable expectations of the typical retail customer, Lipton views the typical investment-manager client, however, as much more sophisticated and the nature of his relationship with the firm much more close, such that these types of disclosures are now much more meaningful.²¹⁴ As has been emphasized throughout, we do not, in the context of difficult-to-price securities, place much weight on these kinds of distinctions. Moreover, although Lipton does acknowledge that an investment bank, unlike a major commercial bank, will not usually have confidential relationships with a large number of clients and that, accordingly, a policy against the investment management division’s trading in securities issued/underwritten by the investment banking division should not unduly impinge upon the range of available investment opportunities—less true today—he suggests that such a policy would nevertheless place investment banks at a disadvantage with respect to commercial banks in the competition for investment management business.²¹⁵ In response to this, we say “good” because unlike Lipton, we

212. *See id.* at 502.

213. *Id.* at 503.

214. *Id.* at 508.

215. *Id.* at 509.

believe that the investment management conflict problem *is* of sufficiently important moment to warrant imposing such a competitive disadvantage.

Indeed, the idea of one employee's not communicating information to another employee, the receipt of which would result in significant profit or the avoidance of significant loss, appears in our view so contrary to human nature and temptation as to be wholly unworkable as a valid, legally recognizable defense.²¹⁶ The law must have as its essential foundations as realistic a view of human behavior as possible. Recognizing an information-barrier defense in this context would seem to fail this test rather emphatically, where the experience of the financial sector has, time and time again, cast substantial doubt on the effectiveness of voluntary restrictions on the flow of information within a single firm.²¹⁷ Rather, the weight of empirical evidence appears to establish just the opposite—that such walls do not work particularly well in practice, with large securities firms having repeatedly sought to establish separate underwriting divisions only to find the attempted structural separation to have been wholly inadequate as a means of preventing inside information known to its underwriting division from also becoming known to its brokerage or investment management divisions or both.²¹⁸ For all the foregoing reasons, we thus reject the claim that the information-barriers approach represents a truly workable means of limiting the conflicts of interest that invariably arise where investment advisers “affiliate” with securities-related businesses—most notably, issuers/underwriters.

2. Eliminating the Fiduciary Responsibilities of Broker-Dealers

Consider an ordinary sales transaction of a security from a broker-dealer to an investor. Generally speaking, there are three types of communications that can be made by the broker-dealer with respect to this transaction: (1) security *X* is for sale into your account, (2) security

216. As the Second Circuit noted in *Slade v. Shearson, Hammill & Co.*, 517 F.2d 398, 402 (2d Cir. 1974), it is one thing to establish an information barrier for prophylactic purposes and quite another to use that barrier as a valid legal defense against liability.

217. A respectable number of securities industry professionals share the view that “[a]nyone who believes in Chinese Walls in the secondary markets believes in fairies.” Interview with Peter Quinnen, Chairman, James Capel & Co. (Feb. 25, 1987), quoted in Norman S. Poser, *Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K.*, 9 MICH. Y.B. INT'L LEGAL STUD. 91 (1988).

218. See, e.g., *Slade*, 517 F.2d at 401; see also SEC. & EXCH. COMM'N, 34TH ANNUAL REPORT 8–9 (1968) (concluding that Merrill Lynch was unable to successfully keep within its underwriting division information concerning the decreased earnings of Douglas Aircraft).

X is for sale, and I recommend that you purchase it for your account, or (3) security *X* is for sale, and I have purchased it for your account. In some ways, the nature of the relationship can be determined and defined solely on the basis of these three types of communications alone. The first, for instance, corresponds to the fully nondiscretionary account, meaning that the customer makes the investment decisions and the broker merely receives and executes the customer's order. This relationship does not give rise to a general fiduciary duty²¹⁹—only to the lesser duty of suitability and other related ministerial requirements.²²⁰ The third communication, on the other hand, corresponds to a fully discretionary account. In this situation, the broker-dealer assumes a role equivalent to an investment adviser, and the fiduciary duties and obligations associated therein thus attach here.²²¹

It is the second communication where things become a bit more complicated, namely, the case where the investment adviser offers some form of investment advice in connection with a security sales transaction. Section 103 would solve the thorny issue of investment advice—the second situation—by rendering the fiduciary duties owed to retail investors by broker-dealers equivalent to those owed by investment

219. See, e.g., *Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc.*, 157 F.3d 933, 940 (2d Cir. 1998) (holding that under New York law “there is no general fiduciary duty inherent in an ordinary broker/customer relationship,” that “[s]uch a duty can arise only where the customer has delegated discretionary trading authority to the broker”); see also *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999) (securities); *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270 (S.D. Ohio 1996) (derivative swaps); *Fekety v Gruntal & Co.*, 595 N.Y.S.2d 190 (App. Div. 1993) (securities).

220. See, e.g., Barbara Black, *Brokers and Advisers—What's in a Name?*, 11 *FORDHAM J. CORP. & FIN. L.* 31, 36–37 (2005) (contrasting broker's duty of suitability with adviser's fiduciary duty, including duty to monitor and to avoid self-dealing transactions without informed consent); John C. Coffee, Jr., *Changes Needed Before Fed Is Given Regulatory Mission*, N.Y. L.J., July 16, 2009, at 5, 5–6 (contrasting broker's duties of suitability imposed by FINRA with investment adviser's duty); see also Michael Koffler, *Six Degrees of Separation: Principles To Guide the Regulation of Broker-Dealers and Investment Advisers*, 41 *SEC. REG. & L. REP.* (BNA) 776, 781 (2009).

221. See, e.g., *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978) (noting that by acquiring fiduciary status, the broker-dealer handling a discretionary account is required to “(1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history . . . ; (3) keep his customer informed as to each completed transaction; and (4) explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged” (citation omitted)). Furthermore, where the broker handling a discretionary account engages in an active trading strategy, “particularly where such trading deviates from the customer's stated investment goals or is more risky than the average customer would prefer, he has an affirmative duty to explain the possible consequences of his actions to his customers.” *Id.* at 954.

advisers—the third situation.²²² It is important to understand that if enacted by Congress as written, section 103 would represent a dramatic departure from current law in most jurisdictions—notably, New York, where state law governs the vast majority of customer agreements entered into by securities broker-dealers.²²³

a. The Distinction Between Broker-Dealers and Investment Advisers Must Be Drawn as Sharp and as Bright as Possible

In support of establishing a fiduciary duty for broker-dealers offering investment advice to retail investors, the Treasury White Paper argues that “retail investors are often confused about the differences between investment advisers and broker-dealers.”²²⁴ Although no doubt true, introducing legislation that would heighten the duty owed by securities broker-dealers offering investment advice to retail customers who maintain nondiscretionary securities brokerage accounts would seem to only further increase, not decrease, this understandable confusion. We argue, by contrast, that the particularities of the broker-dealer relationship are better suited to bright-line rulemaking, and not to the enactment of

222. See Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 7103 (2009) (enacted).

223. See, e.g., *Liberman v. Worden*, 701 N.Y.S.2d 419, 420–21 (App. Div. 2000) (holding that a broker-dealer does not owe a fiduciary duty to a customer who maintains a standard nondiscretionary account); *Perl v. Smith Barney Inc.*, 646 N.Y.S.2d 678, 680 (App. Div. 1996). Under New York law, such customers are owed limited duties that arise on a transaction-by-transaction basis only; specifically, a broker-dealer owes its nondiscretionary account customers “duties of diligence and competence in executing the client’s trade orders, and is obliged to give honest and complete information when recommending a purchase or sale.” *De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002). The duties owed by a broker-dealer to a nondiscretionary account customer “ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer’s investments.” *Id.* In other words, a customer who maintains a nondiscretionary account “may enjoy the broker’s advice and recommendation with respect to a given trade, but has no legal claim on the broker’s ongoing attention.” *Id.*; see also Richard A. Rosen, *The Kwiatkowski Decision: Implications for the Nature and Scope of Duties of Brokers and FCM’s to Their Customers*, FUTURES & DERIVATIVES L. REP., Dec. 2002, at 10.

224. TREASURY WHITE PAPER, *supra* note 5, at 71; see also ANGELA A. HUNG ET AL., RAND INST. FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 40 (2008), available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf (suggesting several possible reasons for this confusion, including interchangeable titles used by financial firms—the term *financial adviser* is often used by both broker-dealers and investment advisers—and including the use of “we do it all” advertisements that blur the distinction between broker-dealers and investment advisers).

vague and ambiguous standards ostensibly embodied in legal concepts such as “fiduciary duty” and “investment advice.” In this context ex ante predictability and certainty are of paramount importance. Investors must be presented with sharp and understandable rules that make clear and set forth the exact nature of their relationships to the intermediaries with whom they are forced to interact within the financial system.²²⁵

In other words, the principal focus here must lie in maximizing the *salience* for investors of the nature of the various duties and obligations owed to them. As long as the full scope of these duties and obligations is disclosed to investors in a clear and sensible way, ex post fairness and the need for flexibility remain only as peripheral concerns. This is true, so the argument goes, because the expected benefits of further blurring the legal distinctions between investment advisers and broker-dealers—as House Bill 4173 contemplates—are more than outweighed by the expected costs of additionally muddling the reasonable expectations of investors, who, in setting foot into the dark and muddy waters of the financial system, must now interrelate with a vast and wild panoply of different financial creatures, many of whose underlying purposes and motivations are not always immediately apparent—or benign.

This blurring is defended on the basis of prior empirical research demonstrating that an investment adviser and a broker-dealer providing “incidental” advice²²⁶ appear virtually identical from the vantage point of the retail customer.²²⁷ Indeed, the Treasury White Paper goes as far as plainly concluding that the distinction is “no longer meaningful” and that the current statutory and regulatory framework is “based on antiquated distinctions between the two types of financial professionals that date back to the early 20th century.”²²⁸ We are not nearly so prepared to

225. See Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 400–01, 406 (1985); see also Clayton P. Gillette, *Rules, Standards, and Precautions in Payment Systems*, 82 VA. L. REV. 181, 230–31 (1996); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 589, 622 (1992); Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 25–26, 43 (2000); Eric A. Posner, *Standards, Rules, and Social Norms*, 21 HARV. J.L. & PUB. POL’Y 101, 116 (1997).

226. See 15 U.S.C. § 80b-2(a)(11)(C) (2006) (excluding from the definition of the term *investment adviser* “any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore”).

227. See HUNG ET AL., *supra* note 224, at 4, 113 (conducting a national household survey with 654 respondents and holding six focus groups in September 2007 to gauge the extent to which investors understand the differences between broker-dealers and investment advisers and concluding that as the industry becomes increasingly complex, with financial firms increasingly more heterogeneous and intertwined, investors, as a consequence, increasingly lack a clear understanding as to the different functions and fiduciary responsibilities of these two financial professionals).

228. TREASURY WHITE PAPER, *supra* note 5, at 71.

deem as irrelevant the enduring wisdom of our legislative forefathers. Broker-dealers and investment advisers—as hopefully our stylized conceptual framework makes clear—play distinct roles in the financial system and are characterized by important differences.²²⁹ As was the intent of the original drafters, the securities laws should recognize and attempt to make as salient as possible these fundamental differences and not paper over them with conclusory statements that such views are now “antiquated” as regards the realities of today’s financial marketplace.²³⁰

Indeed, as will be discussed more specifically in Part IV.B, the market-making activities of broker-dealers invariably result in certain conflicts of interest that just do not—or should not—apply in the context of investment management. The broker-dealer, who makes money on the difference between the bid and ask price of a security, is continuously striving to buy as low or sell as high as possible. As an investor on the opposite side of a transaction, the broker-dealer—in ways not applicable to the investment adviser—is thus always striving to some extent to screw you, the investor, over. That is, in selling at the highest price asked or buying at the lowest price bid, the broker-dealer—even if he or she knows or strongly suspects that the ask price is too high or the bid price too low—is under no obligation whatsoever to give you a bargain, and this remains true regardless of whether or not the broker-dealer is selling out of his or her own inventory of securities or transacting at the request of another client-customer.

In structuring the securities statutes as they did, the original drafters were more than well aware of this harsh reality of financial market-

229. See, e.g., Aguilar, *supra* note 19.

230. See, e.g., Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 *BUS. LAW.* 396, 412–13 (2010). In this interesting paper, Laby argues that changes in the way brokers market their services as well as changes in the type of compensation charged have altered the nature of the relationship between brokers and their customers. *Id.* at 416, 422–23. In our view, this is not indicative of a change in the underlying relationship, just the compensation structure—and confusingly so. Laby further argues that changes in securities trading resulting from changes in technology have rendered brokerage a commodity that no longer entails the level of judgment and skill required to conduct brokerage services in the bygone era of the early twentieth century. See *id.* at 412–16. This does not appear to be an accurate description of today’s high-frequency algorithmic trading shops, for example, that seem to hire almost exclusively young graduates from Cal Tech and M.I.T. Indeed, with the advent of so much financial innovation, it is not entirely clear that, as compared with eighty years ago, the ever-changing business of market-making differs more, not less, from the provision of investment advisory services.

making.²³¹ Today, it remains the job of securities law to ensure that investors remain similarly aware. Investors must understand that their best interests are not always well aligned with the broker-dealers with whom they transact, that the Walrasian auctioneer is not always acting to maximize the rate of return subject only to the investor's stated risk preferences—as do investment advisers, ideally. Rather than attempt to ignore or gloss over this important fact, advocates of financial reform would be wise to understand and accept this as an essential aspect of market-making activities and of providing liquidity to the market, and design and promote laws that accordingly make this distinction as *salient* as possible to investors.

Indeed, it is not so terribly important how the line is drawn—be it on the basis of whether the customer account is discretionary or nondiscretionary or whether the method of compensation is fee-based or asset-based²³²—only that it be as clear and as bright as possible that investors know, right from the start, on what side of the line they stand—whether they are dealing with ally or with foe—and that where the investor does indeed choose to go it alone, the investor not be allowed to seek recompense for losses incurred as a consequence of that choice from those who happened to incidentally offer investment advice at some point along the way. The Investor Protection Act, in having the nature of the fiduciary duty depend on whether the retail investor can properly be characterized as having received financial investment advice—a factual determination sure to be fraught with all kinds of evidentiary difficulties—creates significant uncertainty along these lines and thus fails this decidedly important test.

B. In Support of Proprietary Trading

Finally, recall from above that section 103 of the Investor Protection Act is written so as to empower the SEC to promulgate rules and regulations providing that the “standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers . . . shall be to act [solely] in

231. See Flynn, *supra* note 157.

232. In 1994, the SEC released the Tully Report, concluding, among other things, that firms should base at least a portion of a registered representative's compensation on assets held in an account, regardless of whether any transactions occur, which, in turn, unhelpfully precipitated a move by certain broker-dealers to offer fee-based brokerage services in lieu of commissions. See DANIEL P. TULLY, WARREN E. BUFFET, RAYMOND A. MASON, SAMUEL L. HAYES III & THOMAS E. O'HARA, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES 5–6 (1995). Contrary to the Tully Report, we are skeptical of such blurring of the lines and would argue instead in favor of drawing a sharp distinction between charging brokerage commissions and asset-based fees.

the best interest of the customer.”²³³ Of course, financial intermediaries should not be actively striving to structure and recommend investment strategies that run counter to the best interests of their clients. But we worry that the above-cited language, coupled with language in the Volcker Rule to the effect that the ban on proprietary trading might also apply to certain nonbank financial entities,²³⁴ goes further than that, appearing to endorse a regulatory philosophy directly contrary to the one set forth in this Article insofar as it emphasizes reducing the extent to which broker-dealers and investment advisers are allowed to have a personal financial stake in the various investment strategies that they advise and recommend to their investor-clients.

Placing this within our conceptual framework, one possible consequence of this regulatory approach would be to discourage—by punishing those decisions that a regulator deemed not “[solely] in the best interest of the customer”²³⁵—the extent to which broker-dealers and investment advisers invest their own hard-earned money in the business—in the process, of course, thereby exacerbating the negative consequences of the behavioral effects isolated and discussed above. In other words, where Congress may be content to place more weight on greed and self-dealing, we think it better to place more emphasis on research effort and well-informed decisionmaking. We believe that it is better to have financial actors who are well informed but sometimes try to screw us over than it is to have such same actors who are disinterested but have no idea whatsoever what they are doing. At least if financial actors are well informed, then we can always come back to the disclosure model and think carefully about how this knowledge and information might be publicly disclosed in some meaningful way, rather than have to resort to more intrusive steps, such as those as envisioned by section 103, directly regulating how private companies choose to compensate their own employees.²³⁶

233. See Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 7103 (2009) (enacted).

234. See *Volcker Rule*, *supra* note 4.

235. See Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 103(a)(2) (2010).

236. See H.R. 3817 § 103 (2010).

1. Two Arguments for Allowing Proprietary Transactions with Respect to Broker-Dealers and Investment Advisers

There are at least two arguments that can be made to explain why, with respect to broker-dealers and investment advisers as defined herein, we might want to encourage, rather than proscribe, proprietary trading and other principal investments of this kind: (1) the task of defining what properly qualifies as proprietary trading does not appear to be grounded in a coherent theory as to why it should be proscribed in the first place, and (2) proprietary traders are less likely to exhibit the house money and earned money effects introduced above.

a. A Distinction Void of Theoretical Content

We suggest that proprietary trading, as defined in the Volcker Rule, is wanting a coherent theoretical underpinning, and as a result, it is vague and ambiguous, with the regulation of this not well-defined activity therefore likely to be relatively costly in terms of the inevitable need for elucidative administrative and judicial rulemaking. In particular, the Volcker Rule makes a distinction between, on the one hand, purchasing and selling securities for the “institution’s or company’s own trading book” and, on the other hand, doing so as “part of market making activities.”²³⁷ This seems a distinction without real meaning in that market-making activities will almost always involve trading on the firm’s “own trading book.”²³⁸

It would seem that the distinction finds its most compelling theoretical basis where conceived as an attempt to sequester a particular subset of trades wherein the broker-dealer is likely to be unacceptably conflicted vis-à-vis nonproprietary customers—an attempt that arguably reflects a more general tendency on the part of commentators and other social analysts to want to describe all financial failures and all financial crises as the direct result of a Wall Street culture of unbridled *greed* run amok, a case of out-of-control egomaniacs ever-fattening their wallets to the detriment of innocent and otherwise unwitting investors.²³⁹ To the extent

237. *Volcker Rule*, *supra* note 4.

238. Moreover, the phrase *market-making activities* seems impermissibly broad, opening up the possibility for all sorts of transactions to be improperly described as market-making in an attempt to avoid the ban on proprietary trading.

239. See, e.g., CHARLES GASPARINO, *THE SELLOUT: HOW THREE DECADES OF WALL STREET GREED AND GOVERNMENT MISMANAGEMENT DESTROYED THE GLOBAL FINANCIAL SYSTEM* (2009); MARK GILBERT, *COMPLICIT: HOW GREED AND COLLUSION MADE THE CREDIT CRISIS UNSTOPPABLE* (2010); BARRY RITHOLTZ, *BAILOUT NATION: HOW GREED AND EASY MONEY CORRUPTED WALL STREET AND SHOOK THE WORLD ECONOMY* (2009); ANDREW SPENCER, *TOWER OF THIEVES: INSIDE AIG’S CULTURE OF CORPORATE GREED*

that this characterization of the underlying concerns and motivations is correct, we argue that the Volcker ban misses the mark insofar as this self-dealing by securities traders is far more extensive than would be otherwise suggested by how the line is presently drawn.

To amplify, consider the three different forms of trading that typically take place in a financial firm providing liquidity to the market: (1) proprietary trading, (2) principal transactions, and (3) agency trading.²⁴⁰ The term *proprietary trading* can generally be defined as trading on behalf of the firm's account.²⁴¹ Proprietary traders buy and sell at their own discretion, with the primary purpose of seeking profit potential for the firm's account, independent of the commission- and spread-based trading that defines the flow and is the main focus of principal traders; that is, proprietary trader's profits and positions are driven by the success of their trading strategies and models and not by arbitrage or repositioning around client-driven trade execution.

Principal transactions, by contrast, occur where the trader provides liquidity by committing capital to the opposite side of a client-driven trade.²⁴² In particular, if the client is a buyer, then the trader is either selling from inventory or taking a short position; if the client is a seller, then the trader is either adding to inventory or taking a long position. Principal transactions fit into the broader category of flow trading.²⁴³ Note that the majority of securities traders at the major brokerage houses are flow traders, not proprietary traders,²⁴⁴ where also included within flow trading is agency trading, in which the broker acts solely to execute

(2009); *see also* ROBERT BRYCE, PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON (2004); BRIAN CRUVER, ANATOMY OF GREED: THE UNSHREDDED TRUTH FROM AN ENRON INSIDER (2002).

240. In electronic financial markets, the term *algorithmic trading* refers to the use of computer programs for entering trading orders with the algorithm deciding on aspects of the order, such as the timing, price, or quantity of the order, or in many cases initiating the order without human intervention. Algorithmic trading may be used to implement any one of the three different forms of trading.

241. *See generally* MARK T. WILLIAMS, UNCONTROLLED RISK: LESSONS OF LEHMAN BROTHERS AND HOW SYSTEMIC RISK CAN STILL BRING DOWN THE WORLD FINANCIAL SYSTEM 74 (2010).

242. *See id.*

243. *See id.*

244. *See, e.g.*, Cyrus Sanati, *Wall St. Tries To Put a Price on Volcker Rule*, N.Y. TIMES DEALBOOK (Jan. 28, 2010, 6:33 PM), <http://dealbook.nytimes.com/2010/01/28/wall-st-tries-to-put-a-price-on-the-volcker-rule/>.

trades for the client by buying and selling securities, typically equities, on a commission fee basis only.²⁴⁵

It is important to understand that most principal transactions also take on some proprietary risk as well. Somewhat confusingly, this risk is commonly referred to as “principal risk,” which refers to the direct market exposure of the firm’s account in being on the opposite side of a transaction with a client—as opposed to an agency transaction where the firm takes on no risk and only charges the client a fee for its services.²⁴⁶ Although the amount of principal risk assumed by the trading desk will vary according to the firm and product, rarely will a desk be perfectly hedged; normally, it will have some principal risk exposure by, for instance, choosing to remain long after buying an asset from a client. The likely reason for the confusion in this area is that under both types of transactions, the firm has exposure with respect to its profit and loss statement. The difference, of course, is that the primary purpose of a proprietary transaction is the assumption of risk, often across multiple asset classes—you have an idea and you risk the firm’s capital on it—where, by contrast, for principal transactions, this exposure is mainly a byproduct of the retail flow—you take the other side of a trade to earn a spread, and this cannot be done without exposure however temporarily the position is held—which, unlike proprietary trading, is often limited to the specific product expertise of a given trading desk.

Observe, though, that these principal transactions result in exactly the same kinds of conflicts of interest that in all likelihood so irk proponents of the ban on proprietary trading. To see this, consider, for example, the question of what happens where an important institutional client is right on market direction: the market is plummeting, and the client is selling into it by asking a principal trader to serve as the buyer in the falling market. It is a delicate situation with respect to managing client relationships.²⁴⁷ What price to bid? The principal trader has to show a price in the context of the market. If the bid is too low, then the trader runs the risk that the client will be insulted and the relationship permanently impaired. The trader could widen the bid/ask spread to reflect the increased risk in trading in the asset and better cover turnover costs. Provided there is a buyer to match against the seller—where real money sometimes does buy independent of the market—the trader could set up a riskless trade. Similarly, the asset could be overhedged on the expectation

245. See Robert D. Arnott & Wayne H. Wagner, *The Measurement and Control of Trading Costs*, FIN. ANALYSTS J., Nov.–Dec. 1990, at 73, 78.

246. See Richard Dale, *Risk Management in U.S. Derivative Clearing Houses*, 3 Y.B. INT’L FIN. & ECON. L. 13, 16 (1998).

247. The assumption here is that it is simply bad business to tell an important client that a bid is not available.

of further price depreciation, or alternatively, the client might be convinced that now is not the right time to unload the asset, assuming, of course, that legitimate reasons exist for saying so, and if not, the trader might step in as an agent and work the client out of the asset. The point of all of this is not necessarily to identify which response is the correct response but only to highlight the difficult conflicts of interest that predictably arise when trading as a market-maker, even where that trading might not be properly classified as proprietary trading as that term is defined under the Volcker Rule.²⁴⁸

Indeed, it is really only the agency broker who is truly free of the kinds of conflicts presumably motivating the reform proposals, and the agency broker is an endangered species, everyday becoming increasingly less relevant with the ever-growing number of electronic communication networks (ECNs) and dark pools—crossing networks that provide liquidity where neither the price nor the identities of the counterparties are displayed on the order books²⁴⁹—where, moreover, it does not require a great deal of imagination to envision how a firm engaged only in agency trading might very naturally soon expand its market-making operations into principal and proprietary transactions.²⁵⁰ The Volcker Rule would attempt to proscribe only the latter expansion. Rather than expend costly regulatory resources to monitor and enforce this vague and ambiguous distinction, which, as we have seen, cannot be supported on the theoretical basis of eliminating conflicts of interest alone, we advocate the exact opposite position—more proprietary trading, not less.

248. See *Volcker Rule*, *supra* note 4, § 13(f)(1).

249. See Concept Release on Equity Market Structure, 75 Fed. Reg. 3594, 3598 (proposed Jan. 21, 2010) (to be codified at 17 C.F.R. pt. 242) (stating that today's increasingly complex financial markets have broken up into four distinct sectors: (1) registered exchanges (63.8%); (2) ECNs (10.8%); (3) dark pools (7.9%); and (4) trading inside broker-dealers (17.5%)).

250. The following question may have occurred to the reader: why do investors need to go through an agency brokerage to buy and sell securities? Is that not what, say, E*TRADE is for? The answer is the *size* of the transactions. If a mutual fund wishes to buy one million shares of stock, it would be too large for the market to absorb, disrupting the share price substantially. The job of the agency trader is thus to divide the order into smaller pieces and buy various portions at certain intervals throughout the day, that is, to execute optimal order timing and order routing.

b. Failing To Take Account of Important Behavioral Effects

Further, banning proprietary transactions as a fix to the somewhat misconceived conflict of interest problems discussed above would serve to aggravate the house money and earned money effects that have been identified at several points throughout this Article as being particularly important when trading in difficult-to-price financial instruments. In our view, the trouble arises in the issuance and subsequent market-making of these securities not so much because arbitrageurs are relentlessly subordinating the best interests of their clients in a mad dash to make as much money as humanly possible but more because all too often nobody really knows what is going on or what the hell they are doing. Large sums of money cannot be unaccounted for at various points in time. The different trading desks do not communicate with each other. Managers and directors are hopelessly unfamiliar with fundamental aspects of the very businesses over which they are purportedly in charge.

And all of this takes place in part because a lot of money is being made in the short run but also in larger part because the actors involved are endowed with the luxury to be ill informed as such. What is the worst case scenario? That someone else's hard-earned cash is lost, that the trader is fired—only to take up work across the street in due course. It is not the trader's money that is actually at risk; it is not the trader's life savings that might be lost. The trader's money is safe and sound, and the knowledge that this is true—that the stakes are not nearly so high for these importantly positioned financial actors as they are for those whose money is truly at risk—leads to such disastrously ill-informed risk-taking behavior.²⁵¹

With this in mind, policy proposals seeking to promote financial regulatory reform in the context of difficult-to-price securities should therefore be more properly directed towards promoting a broader, far-reaching understanding of these securities as they are bought and sold in the secondary market—as well as in the primary market for that matter—than towards prohibiting certain misconceived conflicts of interest and sales practices that are not so much contrary to the best interests of investors as they are often necessary for such market-making to occur in the first instance. In other words, we should *not* ask, How do we get certain financial players to act solely in the best interests of their clients?, but rather we should ask, How do we get these very same players, who buy and sell difficult-to-price financial products from and to the investing public, to sit down and actually spend the long, often painful hours

251. And this has been generally true for well over a hundred years now. *See generally* LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* (1914).

necessary to understand and appreciate exactly what it is that they are making a market?

V. CONCLUSION

In sum, the claim is that what tends to cause problems where transacting in difficult-to-price securities is not so much excessive risk-taking per se but rather a fundamental cluelessness as to whether or not these risks are excessive in the first place. By entrusting money to the hands of purely disinterested financial advisers who are, in turn, subject to certain behavioral effects giving rise to uninformed risk-taking behaviors, the claim is that such regulated funds will be made ever more the hapless, unsuspecting targets of sophisticated, fully motivated financial actors lurking ominously in the shadowy background of a largely unregulated de facto banking system. No, the correct approach is to establish and promulgate rules and regulations that effectively replicate the incentives confronted by those who trade at firms with typical hedge fund-like governance structures. The more aligned the incentives are as a consequence, the lower the agency costs, and thus the better the quality of decisionmaking. Instead of passing legislation specifically designed to eliminate or reduce the salutary impact of proprietary transactions upon incentives, this Article argues for just the opposite—that legislation be passed to make the incentives facing broker-dealers and investment advisers and investment banks look more like those of the typical hedge fund, not less.

