Knight

Current Perspectives on

Modern Equity Markets

A Collection of Essays by
Financial Industry Experts

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CHAPTER 10

The Importance of Financial Policy Makers Making Informed Decisions

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Sound financial regulatory policy is critical to the United States' economic and social well-being. Financial regulation establishes the ground rules for how the financial markets operate and financial claims are created and traded, and it ensures that investors are protected, that contracts are spelled out, and that property rights are respected. Sound regulation fosters robust capital markets that channel capital from investors to its most productive users, including corporations and other enterprises.[1] If markets function well, then funds flow from investors to firms with a minimum of friction and loss. Low costs lead to greater liquidity and a higher value for financial claims. If security prices are higher, then firms' costs of capital are lower, allowing firms to maximize investment possi-

1 For a general discussion of the importance of financial systems, see R. C. Merton and Z. Bodie, "A Conceptual Framework for Analyzing the Financial System," Chapter 1 in Crane et al., *The Global Financial System: A Functional Perspective* (Boston: Harvard Business School Press, 1995).

bilities. This investment leads to economic growth and greater wealth for the economy.[2]

This chapter discusses the importance of informed financial policy making in securities markets. It begins by describing the regulatory process. It then discusses what it means for policy makers to be informed within a regulatory context, including a discussion of the costs of *not* being informed. The chapter concludes with several examples of successful and unsuccessful regulatory decisions.

The Regulatory Process

Financial policy making is, by its very nature, a disorderly process. It requires policy makers to balance the conflicting objectives of a number of participants in the financial system, including investors, issuers, intermediaries, and government entities. As a result, policy changes may convey benefits to one or more of these groups while imposing costs on at least some of the others. Deciding what costs to impose on which groups, as well as whether the costs are worth the attendant benefits, is a central task of financial regulation.

In the United States, securities markets are regulated by the Securities and Exchange Commission (SEC). Established by Congress in 1934, the SEC regulates the issuance of securities, corporate actions such as mergers and tender offers, stock and option exchanges, broker-dealers, mutual funds, and many aspects of conduct by securities market participants. The SEC is charged with protecting investors and promoting capital formation. Congress requires it to consider the costs and benefits of the regulations that it propagates, as well as the impact of proposed regulations on small businesses.

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2 For a more complete discussion, see C. M. Jones and E. R. Sirri, "Examining the Main Street Benefits of Modern Financial Markets," U.S. Chamber of Commerce, March 2010, www.uschamber.com/publications/reports/1003financial.htm.

The SEC's key mechanism for regulation is passing rules pursuant to authority under its enabling statutes. In its most simple form, the rule-writing process consists of four steps:

1. The SEC conceives of the need for regulation. Need can be perceived in several ways: through observing the environment, receiving requests from firms or individuals in the financial system, responding to legislative requirements, or following the agenda of the SEC Chairman and Commissioners.
2. The SEC drafts and then formally proposes a new rule or set of rules.
3. The proposed rules are published for public review and comment, typically for a period of 60 to 120 days.
4. The SEC reviews the comments it receives on the proposed rules. It then elects to adopt the rules as originally proposed, to abandon its rule-making, or to adopt modified versions of the rules based on public comment and other information learned during the pendency of the proposal.

Being an Informed Regulator

The SEC seeks to be informed about the issues over which it has authority. Although being informed may appear on the surface to be straightforward, the financial markets are very complex and constantly evolving. Certain aspects of the financial markets—such as the issuance process for securities and the strategies of mutual funds—change relatively slowly. Other segments—especially those related to broker-dealers and trading—change much more rapidly. Because of the speed of change and the sensitivity of the markets to small changes in regulation, the SEC must be well informed throughout its policy process to make good decisions.

Stating that it is important to *be* well informed and actually *being* well informed are two different things. The SEC is a regulator ensconced in Washington, DC, while New York, and to a lesser extent Chicago and Boston, are the foci of much of the country's financial activity. The issue

of becoming informed is therefore far from trivial. It takes both adequate resources and a strong process for the SEC to be informed in its policy decisions.

The most important resource for being informed is people. To carry out its objectives, the SEC depends on having strong staffing both in terms of the number of individuals and their skills. The SEC historically has been a lawyer's agency, and it remains so today. One consequence of being a lawyer's agency is that the SEC tends not to make broad use of economic or empirical analysis. To put the SEC's legal emphasis in perspective, fewer than 50 of the agency's 3,500 staff members are economists. Yet the markets that it regulates are consummately economic in nature, at times leading to a disconnect between legal and economic frameworks.

The SEC and its staff attempt to bridge this disconnect in part through contact with practitioners and members of the financial community. It is no secret that the SEC seeks to maintain a good flow of information with the entities that it regulates. It does so in several ways.

First, the SEC has an open-door policy with respect to market participants. As a general matter, any credible market participant can obtain an audience with Commission staff or, if the topic is sufficiently important, with the Commissioners themselves. These meetings serve two important purposes. One is that they allow practitioners to voice their views of shortcomings in SEC policy or approaches to regulatory issues. In short, these meetings give market participants a direct pathway to voice their concerns. Equally importantly, however, the process provides a mechanism for the SEC to learn about details of market operations and industry practices. Knowledge of such details is critical to financial policy making. Alternatively, SEC Commissioners and staff visit market participants. As noted previously, the SEC's policy making divisions are located in Washington, DC, rather than New York or elsewhere. In terms of market proximity, Washington is a lot further from New York than the one-hour plane ride would suggest. The Board of Governors of the Federal Reserve solves this distance problem by maintaining a strong presence through the Federal Reserve Bank of New York. The SEC has

no analogue to the New York Fed, having only a field office staffed with enforcement and examinations personnel.

The second way the SEC seeks market information is through the formal notice and comment process. After a rule has been proposed, the SEC receives comment letters, as well as visits from market participants, seeking to influence the trajectory of the proposed rule-making. These mechanisms provide real-time feedback to the Commission and allow it to fine-tune or alter proposed rules that would otherwise create unintended consequences or fall short of regulatory objectives. The SEC traditionally maintains a very open stance during the comment period, saying little about its future intentions but listening carefully to a broad audience of market participants.

Both these mechanisms serve to inform the SEC and its staff. However, they have several potential shortcomings.

First, relying on practitioner-initiated discussions and conversations with practicing attorneys for information causes the SEC to depend on its regulatees for market intelligence. It would be constructive for the Commission to have its own independent sources of information. For example, the SEC does not, as a matter of course, assign staff the job of being proximate to important segments of the market, such as asset-backed securities, money markets, and corporate bond markets. Staff are not generally asked to update Commissioners and senior staff members on market conditions. This is in contrast to other regulators, such as the Federal Reserve, that maintain teams of people whose job is to have current knowledge of market conditions and practices.

Second, the SEC's existing information sources tend to be legally oriented, rather than empirical or economic. The SEC makes only limited use of standard empirical finance techniques, such as large-scale data analysis and sampling, in its policy work. Using data more aggressively would help the SEC track market trends and changes and identify market practices that are observable only through large-scale data analysis. Similarly, such techniques would enhance the SEC's ability to identify potentially important outliers in the markets that often presage later problems.

It is unclear how or why the SEC's lack of economic and empirical frameworks occurred. Perhaps it occurred because current market knowledge is not required, from a legal standpoint, to administer securities laws. Or perhaps it resulted because the legal profession does not typically require lawyers to be trained to use data. Whatever the cause, the consequence is that the SEC often operates at a substantial distance from the markets and market participants it regulates.

This distance has been recognized by a number of regulatory participants and observers. For example, in 2006, Harvey Pitt, a former SEC Chairman, noted, "The agency relies too heavily on legal doctrinairism. In light of its capital market functions, the atrophied state of the SEC's economic analysis capacity is glaring. A steady flow of relevant information is the lifeblood of sound capital markets."[3]

This sentiment was echoed in a 2009 report by the U.S. Chamber of Commerce entitled "Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission."[4] The report noted that the quality of the SEC's decisions would likely be better if issues were considered from more than just a legal perspective. The report recommended that the SEC "expand the breadth of its staff expertise. Legal and accounting expertise should be complemented with staff experts in capital markets operations and the business operations of regulated entities as well as financial economics."[5]

Likewise, Jonathan Katz, who left the SEC in 2006 after 20 years as Secretary, was quoted in a 2009 *Wall Street Journal* article as arguing, "You need the quantitative, analytical capacity that the agency has never

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3 See H. L. Pitt, "Over-Lawyered at the SEC," *Wall Street Journal*, July 26, 2006.

4 For a more complete discussion, see J. G. Katz, "Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission," U.S. Chamber of Commerce, February 2009, http://www.uschamber.com/assets/ccmc/090211ccmc_sec_speed.pdf.

5 For a more complete discussion, see J. G. Katz, "Examining the Efficiency and Effectiveness of the U.S. Securities and Exchange Commission," U.S. Chamber of Commerce, February 2009, p. 23, http://www.uschamber.com/assets/ccmc/090211ccmc_sec_speed.pdf.

had … You need to start looking at these issues not only as legal compliance issues, but you need to look at them also as questions of national economic policy: How do the markets truly function?"[6] In the same article, Harvey Pitt further noted, "Although the SEC receives many filings of different sorts, it does very little to collect significant data, analyze it, and then disseminate it to other government agencies and the marketplace. … This can lead to ill-informed markets, and ill-informed markets can lead to panic when things get rough, as we've seen over the past year-and-a-half."[7]

The SEC, like all organizations, responds to the tone at the top—the taste of senior management. To the extent that the Chairman, Commissioners, and senior staff demand empirical justification for the SEC's decisions, the staff will respond. But too often, the task of becoming informed through empirical analysis is deemed too slow for rule-making timelines. The careful collection and analysis of data can be time consuming. In times of aggressive regulatory policy, data analysis is often perceived as an unnecessary speed bump. As such, some may view economic analysis as a device for ensuring that regulation is delayed or not passed at all. Of course, such views are often misplaced: More aggressive regulatory policies can be adopted with strong empirical justifications than with weak empirical support.[8]

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6 See T. McGinty and K. Scannell, "SEC Plays Keep-Up in High-Tech Race," *Wall Street Journal*, August 20, 2009, http://online.wsj.com/article/SB125072648384844673.html?KEYWORDS=jonathan+katz&mg=com-wsj.

7 Ibid.

8 For example, see the SEC's decision to require that mutual funds have an independent board chair (Investment Company Governance, SEC Release No. IC-26520 [July 27, 2004], 60 FR 46378 [Aug. 2, 2004]). This rule was overturned in June 2005 by the U.S. Court of Appeals for the D.C. Circuit, because the SEC failed to consider the cost that funds would incur in complying with the new rule and because the Commission failed to determine the economic implications of the rule.

The Consequences of Not Being Informed

The degree to which one is informed about a topic can be viewed as falling along a continuum, ranging from being fully informed to being poorly informed. Being fully informed about any number of topics—and in particular, financial matters—may be prohibitively costly. It is therefore reasonable to ask, How informed is informed enough? What are the consequences of making regulatory decisions while being less than fully, or perhaps inadequately, informed? There are three distinct categories of consequences.

First, inadequately informed policy can lead to ineffective regulation. That is, when policy makers are insufficiently informed about a topic at hand, they may craft a regulation that is ineffective at bringing about the policy change they seek. For example, a regulator may seek to have mutual fund investors make more informed and cost-sensitive decisions. One option to help achieve this goal might be to change prospectus disclosure about certain mutual fund characteristics, such as fees and risks. The regulator might require simpler and clearer fee and risk disclosure information on the front page of the prospectus. If, however, most investors do not read the prospectus and rely instead on a financial advisor or family and friends when making fund purchase decisions, then such improved disclosure will have no practical effect on investors' fund choices. The revised prospectus, although clearer and shorter, might be wholly ineffective in improving investors' purchasing decisions. Only by considering investors' buying behavior in the crafting of rules might a regulator understand the need to incorporate the role of financial advisors and the observed behavior of investors. It should be noted that the Division of Investment Management at the SEC uses investor focus groups to avoid such oversights.

The second consequence of not being adequately informed relates to the cost of regulation. There is generally more than one way to achieve a particular regulatory goal, and a regulator typically seeks to attain the goal in the most cost-effective way. But without adequate information about the environment and market practices, the regulator may find it very difficult to assess the lowest-cost way to achieve the desired regula-

tory outcome. The outcome may be achieved but at a higher cost than necessary. For example, in seeking to ensure that retail customers receive the best execution for their trades, a regulator might require the costly monitoring of brokers or implement a restriction on where brokers can send customer orders. Instead, the regulator could require the low-cost solution of requiring disclosure of information about the quality of executions by various market centers, as well as information about brokers' routing decisions to these market centers. At that point, competition and a fear of negative publicity are likely to cause brokers to provide high-quality executions of customer trades.

Finally and most seriously, instituting a policy change without being adequately informed may create consequences that are not only unpredictable but also potentially more serious than the original policy issue the change was intended to address. A general truism is that it is difficult to predict all of the outcomes that will result from changing the operations of a complex system. When applied to the financial markets, this maxim is particularly true. Because financial market participants are profit-seeking entities whose business models are attuned to rapid change and intense competition, a change in market condition—because of either a regulatory action or an environmental shift—will likely cause market participants to adapt their strategies. This responsiveness means that a change to the system can cause ripples in it that result in outcomes that defy prediction and cause unintended consequences. It is often the case, however, that understanding the institutional setting and economic underpinnings of the system can help the policy maker anticipate and mitigate unintended consequences. To do so requires the policy maker to understand not only the current market structure but also the dynamics and forces that drive competition and change in the market. Armed with such knowledge, the policy maker has a better chance of avoiding the most serious unintended consequences.

These three categories—ineffective regulations, costly regulations, and unintended consequences—are merely convenient groupings of a host of costs that can arise from less than adequately informed policy making. The list of costs is not exhaustive. For example, in a world of

regulatory uncertainty or capriciousness, market actors may refuse to invest for fear of having their investments devalued by uncertain future regulatory action. Physical infrastructure, such as trading systems and communications networks, is notoriously expensive to build and maintain. If regulation is viewed as being uncertain, then firms may elect to forgo investments and improvements for fear that they may be irrelevant later. This type of situation is obviously far from optimal.

Examples

This section will illustrate the points made thus far with several examples of recent regulatory decisions—both well and inadequately informed.

Consider first the SEC's decision made in June 2007 to rescind rule 10a-1, the so-called uptick rule. This rule, which had been in place since 1938, generally prohibited a trader from selling a stock short unless done at a price greater than the last previous different price. Thus, a trader could only sell short in a rising market. This rule was put into effect to halt supposed bear raids in the 1930s. However, due to technological changes in trading, changes in the pricing increment, and various forms of no-action relief granted by the staff over time, the SEC felt this rule should be rescinded. The SEC reached its conclusion in part based on the results of a large-scale, long-term pilot experiment. It compared the price movements and trading of two matched samples of firms over many months, in which roughly half of the stocks that traded on exchanges were removed from the terms of rule 10a-1 on a temporary basis and the remaining shares were subject to the rule. After collecting and analyzing the data, SEC staff determined there was no reason to retain rule 10a-1 and therefore recommended that it be withdrawn. This careful process, which took more than two years, was in many ways a model for rulemaking. In the subsequent credit crisis, many market commentators believed the demise of the uptick rule was at least partially responsible for the decline in the market, but subsequent analysis by SEC staff found no support for this argument.

A second example of well-informed rule-making can be seen with respect to the SEC's posture toward various nontraditional trading venues for equity securities. Beginning in 1997 with order-handling rules[9] and later with Regulation ATS,[10] the Commission delineated a framework whereby stocks could be traded off exchange on new venues that were both more entrepreneurial and more technologically advanced than traditional exchanges. The SEC broke away from the model of concentrated equity market trading on one or two dominant exchanges in favor of enabling a more dispersed model of trading, with new entrants competing with established venues for order flow. As trading practices and trading venues developed and changed, the SEC learned gradually about market evolution and adjusted its regulatory framework. The SEC administered this dynamic landscape based on a set of principles involving transparency, fair access, and orderly markets. The Commission allowed markets to evolve under competitive forces and deliberately took a light regulatory hand, letting matters run their course. Consquently, the subsequent decade saw a marked increase in liquidity with a simultaneous decrease in transactions cost, benefiting both institutional and retail investors. As a result, the United States has the most liquid and deep equity markets in the world.

Unfortunately, not all regulatory decisions turn out this well. As an example, consider the spate of rules related to short selling that the SEC promulgated during the height of the 2008 credit crisis. In less than a year, the Commission deviated from its policy related to the regulation of short selling and through a series of more than a dozen rules, interim final rules, and emergency rules, decreased investors' ability to sell short stocks. The SEC accomplished this by, at various times, forcing investors to pre-borrow the shares, forbidding investors to sell certain stocks, and creating more onerous delivery requirements when selling stocks.

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9 Exchange Act Release No. 37619A, Order Execution Obligations (Sept. 6, 1996).

10 Exchange Act Release No. 40760, Regulation of Exchanges and Alternative Trading Systems (Dec. 8, 1998).

In fact, these rules likely did little to halt the decline of financial stocks. For instance, during the time that short selling in financial shares was prohibited, the value of Morgan Stanley's stock fell 44 percent over two days. In the spirit of unintended consequences, the short-selling restrictions reduced stock market liquidity and raised the cost of capital for firms accessing the markets. Even later, after the crisis but during a period of intense political pressure, the SEC put forth little or no justification for its choices regarding short selling. In February 2010, for example, the Commission instituted a form of "circuit breaker" to restrict short selling when share prices have fallen by 10 percent, despite having little or no evidence to support its decision. In its adopting release, the SEC admitted that it had little empirical support for this policy shift and instead justified the rule in part by appealing to the need to enhance investor confidence.

A final example can be seen in the current debate over money market mutual funds, as reflected in revisions to rule 2a-7 of the Investment Company Act of 1940. Rule 2a-7 sets the terms and requirements by which a mutual fund can operate as a money market fund, holding a constant net asset value of $1.00 per share. During the credit crisis, a number of money market funds were in danger of "breaking the buck." To prevent this calamitous occurrence, the SEC, the U.S. Treasury, and the Federal Reserve acted together to effectively issue a federal guarantee of money fund assets. After the crisis had passed, the SEC adopted revisions to rule 2a-7 that, among other things, restricted the types of securities eligible to be held in a money market fund.

A number of key questions remain unanswered, however, and rule-making in this area is likely not complete, in part because of the federal government's uncertain role in guaranteeing the net asset value of money market funds. Whereas the SEC alone regulated money market funds before the government wrote its guarantee, regulation is now split among multiple federal entities. The SEC performs the substantive regulation of funds, whereas the Treasury and Federal Reserve provide a backstop guarantee in the event of a fund failure. But without a clear articulation by the Treasury and Federal Reserve about their future policy

toward guaranteeing money fund assets, the SEC has no framework on which it can base its regulatory choices about funds. For example, it has no framework for determining whether to continue to allow money market fund share prices to be fixed at $1.00 per share or to force money market funds to have a floating net asset value.

Until this interagency matter has been resolved, it will be difficult for the SEC to make cogent decisions about regulatory policy toward money market funds. Thus at times, a federal policy maker's difficulty in making informed decisions stems not only from a lack of knowledge of the environment but also from a lack of coordination among arms of the regulatory system.

Conclusion

Strong and well-crafted financial regulation is paramount if the United States is to have vibrant and dynamic capital markets. As discussed in the introduction, the benefits of having sound policy extend not only to the financiers on Wall Street but also to individuals who live and work on Main Street. Informed regulation leads to better markets, and better markets lead to higher firm valuations, promoting greater growth and more jobs. If for no reasons other than these, policy makers have an obligation to make decisions based on the best information available to them at the time.

There is yet another reason to base policy making on good information. Financial markets have a unique trait that is both beneficial and insidious: They are self-healing in terms of being able to remediate injury done to them through poorly crafted regulations. Rather than tolerate such regulations, market forces counteract negative aspects by changing institutional structures. This self-healing trait is both a blessing and a curse. It means that, on the one hand, suboptimal regulatory actions are tempered by the markets' adaptive qualities. On the other hand, however, an observer looking back may have a hard time seeing the effects of flawed regulations. As a result, policy makers may be imbued with a false sense of accomplishment, whereby they may incorrectly assume

that because the markets have prospered, their regulatory choices were correct and propitious. How much better the markets would have been had a more informed decision been made cannot be observed, as no one can divine this counterfactual world with any certainty.

In the final analysis, policy makers have an almost impossibly difficult job. Good policy decisions that forestall or prevent harmful outcomes are rarely credited to regulators. Such decisions are like the dog that didn't bark. Instead, it is only when the regulatory system fails that regulators are thrust into the limelight. In spite of—or perhaps because of—this asymmetry, the demand for well-crafted and well-informed regulation remains. It is up to the regulators as policy makers to ensure that they have done all they can to seek out and gather the best information possible and then to use this information to produce the sound regulations on which everyone depends.