

# Regulatory Capture at the U.S. Securities and Exchange Commission

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## I. Introduction

Economists have not been shy in their efforts to explain government decision-making. The optimistic “public interest” approach begins with the proposition that the notion of externalities serves to define the proper role of government, and emphasizes the government’s role in correcting market imperfections that result from externalities. In this view, regulatory agencies may or may not be well informed, but they are well intentioned.

A more cynical “regulatory capture” view focuses on the role of interest groups in shaping public policy. This intellectual tradition has deep roots. Marx argued that big business sought and paid for control of important economic institutions. Stigler [1971], in his theory of regulatory capture, argued that even small business industries could capture their regulators. Stigler incorporates Olsen’s [1965] theory of collective action, which predicts that for a given issue and its interested parties, the smaller the group and the higher the per capita stake, the more likely the group will be successful in organizing and effectively influencing regulatory outcomes. Peltzman [1976], noting the emergence of powerful consumer groups in the 1970s, extended Stigler’s view to incorporate these groups as well, and saw a role for government officials to weigh competing interests and not always choose an outcome that favors business. The further contribution of Laffont and Tirole [1991] was to emphasize the importance of the *complexity* of the issue and the resulting *information asymmetries* between the various interest groups and between the interest groups and the bureaucrats who decide their fate in determining the regulatory outcome.

The U.S. Securities and Exchange Commission is not exempt from these forces. Indeed, if anything the SEC is a more likely candidate for capture for two reasons. First, the lawyers (the majority of SEC professional staff) who work in the regulation writing divisions often find their best, and best by a wide margin, post-SEC employment opportunities working for the regulatees, and must change fields completely if they go elsewhere. Second, the inherent complexity of the institutions of the securities industry and its regulatory apparatus create substantial fixed costs that purveyors of influence

must conquer in order to be effective.<sup>1</sup> These two factors make for powerful forces that push the SEC in the direction of rule changes that help rather than hurt the powerful incumbents of the securities industry.

The SEC is not captured by a single group of regulatees. Instead, it is subject to the influence in three different areas corresponding to its three realms of regulation, each defined by one of the three central pieces of enabling legislation that define the SEC's mission. The Division of Corporate Finance writes and administers the rules pursuant to the Securities Act of 1933, which provides for disclosure regarding the character of securities sold to the public; the Division of Market Regulation writes and administers the rules pursuant to the Securities and Exchange Commission Act of 1934, which provides for the regulation of securities exchanges and dealer markets to prevent unfair practices; and the Division of Investment Management, writes and administers the rules pursuant to the Investment Company Act of 1940, intended to provide for registration and regulation of mutual funds and investment advisers. Occasionally an issue arises that affects two constituent groups and hence two divisions of the SEC, e.g., brokers and mutual funds, or issuers and mutual funds.

## **II. The Division of Market Regulation**

Market Regulation is the division of the SEC concerns itself with the rules concerning stock trading. This division is captured by the two large incumbent organizations that trade stock, the National Association of Securities Dealers, and the New York Stock Exchange.

The New York Stock Exchange is the trading venue where the shares of most large public companies are traded. The NYSE sets its standards for companies that can list on its exchange so that only the largest and most successful companies are found there. The NYSE is mainly a “continuous auction” market, with trading centralized on

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<sup>1</sup> In 1992, the Shadow SEC Committee, a group of academics who are interested in SEC issues, held one of its public meetings to consider several issues before the SEC. The committee voted in favor of recommending that financial disclosures expense stock options granted to employees. But with respect to another issue, “payment for order flow”, the committee choose *not to vote*, having determined after several hours of discussion that the members would need further study of the institutions before they could decide which policy option (ban or permit payment for order flow) was preferred.

the floor of the exchange, and requires its members to bring or send most customer orders to the exchange floor for execution.

The NASD maintains markets for smaller companies, although many companies that were once small but have grown large, notably Microsoft, have chosen to remain listed with the NASD rather than move to the NYSE despite being eligible. The NASD is a dealer market, and member dealers can make a market in any registered stocks they choose. The NASD does maintain central facilities for disseminating dealer quotes in all stocks, and for reporting trades in all stocks, but there is no facility like the “floor” of the NYSE to which all orders are brought. Many members of the NASD are not market makers, but simply order takers who then route customer orders to other members who are market makers. The NASD and NYSE compete for listings (firms who list with them pay a listing fee to have their stock traded) and also as trading venues, as NASD members are allowed to make a market in NYSE-listed stocks, and do attract considerable business away from the NYSE.

The capture of the division of Market Regulation by these two entities manifests itself in barriers to the entry to new competitors. There are two notable cases that merit extended discussion.

### ***A. Instinet***

Instinet is a privately owned computerized trading system. Member/customers of Instinet get a computer terminal, on which they can place their orders to buy and sell stock into the system, where they can be seen by other member/customers. All orders take the form of “limit” orders, that is, offers to buy (or sell) a given amount of stock at a given price. The book of prevailing offers to buy and sell in a given stock, conveniently ordered by price, can be seen by all members, but no names are attached; the orders are anonymous. When an order to buy matches an order to sell, the orders execute automatically. Instinet charges a commission on trades consummated on its system. The size of the commission depends on how much business the member does with Instinet.

Instinet has been a huge success, and by 1995 was executing 20 to 25 percent of all Nasdaq volume. Instinet began its business by subscribing only institutional investors—pension and mutual funds. It was an **institutional network**. The institutional

members valued it for its anonymity. Anonymity is valuable because revealing one's identity and trading plans to one's broker can be costly. Large orders to buy or sell often move price. A broker who gets a large order to buy could first buy some stock himself, then buy for his customer's order, watching the rise in price, and then finally sell the stock he bought for himself at a profit. This is called frontrunning. It is illegal. But it is very difficult to detect, and it is unlikely that institutional investors would have such a strong preference for anonymous trading venues if it did not happen with some frequency.

The institutional traders still did much of their business through traditional brokers because they could not always find a counterparty in Instinet. After much deliberation, Instinet invited the broker/dealer community to join, in order to create a thicker market, and found that these members valued their anonymity in Instinet at least as much as the institutions did. Broker/dealers' quotes in the NASDAQ system—their main means of advertising trading interest prior to Instinet's invitation—were and are accompanied by identities, and even the NASD systems that display just the inside quotes (highest bid to buy, lowest offer to sell), identify the dealers who are posting the inside quotes.

Another benefit of Instinet to both institutional investors and to broker/dealers was that Instinet excluded the brokers whose main business was done with day traders who trade through the Small Order Execution System (SOES). The SOES system was put in place after the 1987 crash in order to give small investors, who could not get through to their brokers on the phone, instantaneous access to the market for small-sized orders. It was expected that the orders executed on the system would be mainly retail, uninformed trades. But instead the system attracted day traders who watched screens looking for markets with stale quotes, that is, where an unalert dealer had allowed the market to drift away without changing his own quote. SOES traders were notorious for choosing their times to trade adversely to the interests of the market makers, and studies of their trades confirm that on average, dealers lose money on SOES trades. Excluding these high cost counter parties was of value to all of Instinet's customers.

Instinet is an NASD member, but only a broker, not a dealer or a market maker, and certainly not an exchange. Instinet holds no inventory and does not trade with

customers; it merely offers customers a facility to trade with each other, and provides clearing services. Hence, it is subject to SEC regulation only as a broker, not as a market maker, nor as an exchange. Yet the services that it offers are very “exchange” like. It is a venue where stocks are, well, *exchanged*. This gave rise to the cry on the part of the NYSE and NASD that Instinet should be regulated as an exchange, and that it was unfair to the traditional exchanges that they bear the burden of exchange regulation and Instinet to escape it. The level playing field called for imposing greater costs on Instinet. This gave rise to at least three efforts on the part of the Division of Market Regulation to impose new regulations on Instinet that would seriously damage its business. One was the effort made by the Division to recommend the adoption of proposed Rule 15(c)-2-10 in the Market 2000 report (this recommendation was killed by the Commission); the second was proposed Rule 17(a)-23 (never adopted by the Commission), and a third was the original version of the proposal for the new Order Handling Rules that became effective in January 1997 (modified by the Commission).

The two proposed rules would have imposed on Instinet three requirements devastating to its business. First, it would have to submit all of its rules and rule changes to the Commission for review and approval. Second, it would have to announce a set of requirements for membership, subject to Commission review, and take all who qualified and wished to subscribe as members. Third, and perhaps least burdensome, it would have to surveil its customers affirmatively for violations of Federal securities laws. The first two requirements would have impaired Instinet’s ability to provide a trading venue mainly free of undesirable counterparties (such as SOES traders)..

The proposed 1996 Order Handling Rules would have forbidden broker dealers to put a better offer into Instinet than into the NASD system, and also would have allowed any broker-dealer, and hence, under the new rules, any customer who placed a limit order with that broker, to execute with an Instinet counterparty, even though not a member of Instinet. This also would have impaired Instinet’s ability to provide a trading venue free of undesirable counterparties.

The “public interest” the Division of Market Regulation was purporting to promote was one of “fairness”. They argued that it since the prices in Instinet were accessible only to Instinet members, and were usually better than those offered over the

NASD's own system (which is accessible by the public), the system was unfair to the non-members of Instinet.

This view of Instinet misunderstands, perhaps deliberately, the nature of stock markets. Among the various costs of doing business for a market maker is the chance that the market maker will trade with someone who knows something she does not, that is, she sells to a customer who knows that the price is to rise, or buys from one who knows the price will fall. The price at which market makers trade must on average cover the cost of such losses. If dealers can distinguish among customers, can discern which are knowledgeable and which are not, they can offer better prices to the customers who impose lower costs on them—the ones who know less. Thus, when dealers advertise the quotes at which they are willing to trade, these quotes should be interpreted as the price at which the dealer is willing to trade with the highest cost (best informed) customers. Customers who do business regularly with a given market maker and have a reputation with that dealer for not being so well-informed can and regularly do negotiate a price better than the quote.

The dealer market has always been a negotiated market.<sup>2</sup> Of the trades for 500 shares or more, 30 to 40 percent take place at prices inside the prevailing quotes. This demonstrates that the quotes are often not the best price available, but rather the price at which negotiation begins. If Instinet's limitation on access is unfair, the negotiated market is also unfair.

But in fact it was not really the unfairness of the Instinet system, but rather that it was taking over the NASD's traditional business and escaping the burdens of regulation that was so objectionable. So far, Instinet's anonymity and shelter from undesirable counterparties has been preserved. But a new threat looms: The NASD's own new proposal for an NASD-run centralized limit order book (CLOB) (in which all customer limit orders would be entered and interact with each other) will, if adopted, put the NASD in direct competition with its own members, including the traditional broker-

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<sup>2</sup> The NYSE is also a negotiated market in the sense that as the specialist and floor traders learn more about the identity and nature of a particular order, they often are willing to "step inside the quotes" by placing a better offer to take a particular trade, and then step back again and wait for the next order. NYSE TORQ data reveal systematic differences in execution quality by customer class. See Angel [1996].

dealers, but especially with Instinet, whose system is explicitly a “members-only” open limit order book.

The vested interests align as follows: The broker-dealer members of the NASD generally oppose the establishment of an NASD CLOB. The institutional traders, including institutional subscribers of Instinet, support the CLOB, but only if they have anonymous access to it. If their orders are seen by a broker-dealer in the CLOB, they regard it as no better than the current system. They are hoping for a deeper, cheaper Instinet.

This brings us to the force that protects Instinet—the customers like it, and it has clear benefits for them. The broker-dealer users of Instinet are of two minds—on the one hand, they would like to retake the business they have lost to Instinet. On the other, Instinet’s presence lowers the cost of doing business with their remaining customers. And if the other dealers use it, an individual dealer cannot afford *not* to use it also. On net, the traditional brokers would be better off without Instinet. But the members of the Commission listen to the customers as well as the NASD and the NYSE, and while the Commission will lean in the direction of rules that erode Instinet’s competitive advantage, they are unwilling to go so far as to adopt rules that will kill it.

Another SEC rule change whose impact on Instinet may be profound is the recent change in the Order Handling Rules, which began implementation in January 1997. A possible interpretation of these rules is that they were intended to force the traditional broker-dealers to be more competitive with Instinet. Indeed, the public statements that led to the rules complained that broker-dealers were placing better-priced offers in Instinet than in the NASD’s own system. Rather than allow competitive forces such as the further growth of Instinet to pressure the NASD into change, the Commission chose to apply the pressure itself. The new rules require market makers to display the prices of customer limit orders *in their quotes* if these orders are priced better than the dealer’s own quote. The new order handling rules have resulted in a substantial narrowing (25 to 35 percent) of quoted and effective spreads in thickly traded stocks (with some increase in volatility, and a decline in the depth of the quotes measured as the number of daily quote changes divided by daily volume), but much smaller narrowing in thinly traded stocks. Precisely how Instinet executions compare with ordinary NASD executions, including

commissions, is not known, and under the current regime, undiscoverable, because the relevant data is Instinet's proprietary data, and Instinet does not share it.

Instinet's role in both the motivation for and impact of the new order handling rules is ironic. One of the main pieces of evidence that both the SEC and the Department of Justice cited as part of their evidence that prices in the dealer market were fixed was that market makers offered better prices through Instinet than they did through the NASD's own system. Here we have a private business, Instinet, doing such an outstanding job of competing with the NASD's traditional way of doing things that the SEC felt compelled to force the NASD to move in the direction of doing the same thing, thus potentially harming Instinet.

### **B. AZX**

AZX is another alternative trading system, also a private business, that has encountered the resistance of the Division of Market Regulation. AZX's system offers investors what is known as a "call" auction market. This marketplace calls forth orders to buy and sell and accumulates them to a pre-specified moment in time, and executes at that time at the price which then equates demand and supply. During the hours while orders are accumulating, the system displays the prevailing demand and supply, and shows the price at which trades would execute if no more orders are entered. Customers are encouraged to submit orders early by lower commissions and finer tick sizes for early-entered orders. Like Instinet, AZX customers trade without a middleman, and pay no spread. Instinet offers continuous trading, with all of the consequent short-run variability in price related to order size. AZX instead offers agglomerated trading at a point in time, which, in principle, ought to afford considerable protection to customers with very large orders, and indeed ought create a trading venue where such large orders could be placed "in the sunshine" to attract counterparties. Like Instinet, AZX has no inventory and does not trade with customers.

A market like AZX is the ideal place to trade for customers who know they have no special information, whether their orders are large or small. Customers without special information should be "patient" traders. That is, they should be willing to wait for the call market, in which they can transact without paying a spread, rather than trade immediately

in the continuous market, where they will almost certainly pay a spread, typically on the order of five percent. Another way to say this is that they should have no demand for immediacy. This set of “no special information customers” should in principle include all retail trades (trades of individual investors), as well as nearly all institutional trades.<sup>3</sup>

Evidence of how efficient a call market can be lies in the experience of the NYSE with its “informal call” markets now held on “triple witching” days. When S&P500 futures contracts and options contracts were introduced, these contracts, plus the options on the larger stocks among the S&P500 all expired simultaneously at the moment of close, for settlement at the closing price on particular Fridays. For those who were delivering or paying stock in these contracts, a particular movement in the price of the stocks could be quite profitable. To attempt to influence these prices, the holders of large positions would send their traders to market to attempt to “bang the close” — to place orders for a few thousand or tens of thousands of shares in order to move the price at which millions of shares would then trade. Since this market has parties with huge positions on both sides, this closing trading can become quite frenetic. Hence the witch in triple-witching.

Responding to the negative publicity surrounding triple witching, the NYSE changed the expiration time (rather, the time at which the settling price was determined) of these contracts from the close to the open of the same Friday, and then instructed the specialists in the larger S&P500 stocks to conduct an informal call by advertising (revealing) order imbalance at the price which resulted in the least order imbalance for the hour prior to the market’s open. Orders for a few thousand or tens of thousands of shares, placed just before the open, when millions of shares on each side have already mainly settled comfortably on a price, cannot move price very much. Thus, with the informal call, there is no opportunity to “bang the open”. An order for a few thousand shares added to the call market cannot move the price at which millions of shares are already poised to trade. As a result, the options and futures on the S&P500 and the

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<sup>3</sup> The original research by Jensen [1965] as well as the most recent research by Carhart [1997] indicates that the average mutual fund does a little bit worse than the market; the more funds spend on research and trading, the more they do worse than the market; and there is no serial correlation in fund performance. Thus, it must be the case that these institutions have no better information than does the rest of the market.

options on the stocks all expire simultaneously, and millions of shares change hands with no particular uproar.

AZX, with its call market, thought it had a better mousetrap, and with good reason. Its founders seem to have subscribed to the public interest view of regulation, and hence revealed their hand to the Division of Market Regulation, and registered with the Division as an Exchange.<sup>4</sup> AZX was rewarded with a “small exchange” exemption from the full regulatory burdens of an NYSE, but also was hobbled by a restriction that precludes any significant growth: its call cannot be held during NYSE trading hours, and in fact was assigned the hour of 5pm, Eastern Standard Time.

AZX’s threat is that it is a *price discovering* system. It is not a “crossing” network like Posit, which matches customer buy and sell orders at a price determined in another venue, either the NYSE or Nasdaq. The staff of the division of Market Regulation is concerned that AZX would discover a price that would be outside the prevailing NYSE quotes at the same moment. This concern reflects the division’s belief that if there are multiple prices at the same time, *someone is being cheated*. By assuring that there is only one prevailing price at any moment, no such inference can be drawn. The division is most vexed when a non-NYSE member, “third market” dealer such as Jefferies reports a trade in an NYSE stock at a price outside of NYSE quotes, even if it is for a far larger quantity of stock than is being offered at the NYSE. Somehow those who had offers to trade at better prices at the NYSE (the extant limit orders at the NYSE at better prices) “should” have had their orders filled, and would have if the Division’s opinions regarding the centralization of trading had prevailed everywhere. The Division’s rationale for consigning AZX to the hours when most traders were tired and or had gone home was the fear that this upstart system would “trade through” the NYSE, and do it for a volume large enough to call into question whose price was more legitimate.

Had AZX not been so devoted to the notion of being an exchange, and registered as a broker-dealer instead of an exchange, and operated its system as an NASD broker, perhaps it could have chosen a more popular trading time (every day at the NYSE open?)

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<sup>4</sup> Instinet registered as a broker-dealer when computers were slow and clunky and it traded a non-threatening volume, and then as computers got better, it grew quietly inside the NASD, becoming a stealth exchange.

and be a major venue now. Or perhaps its growth and the competition it offered would have prompted the NYSE to run its own call. But at this point, the NYSE has introduced only enough of a call to avert the adverse publicity of triple witching. And it is easy to see why the NYSE resists a call: Any business that a call would take away from its more profitable continuous trading business would make the NYSE less valuable. But by choosing to try to cooperate with the staff of Market Regulation, rather than taking the stealth approach of Instinet, AZX seems unlikely to ever grow large enough to incite the Division to attempt to put it out of business by rulemaking.

### **III. The Division of Investment Management**

The Division of Investment Management is captured by the trade group that represents mutual funds, the Investment Company Institute. The incumbent firms in the industry are, not surprisingly, largely content with the status quo. The status quo is one in which the central legal document and sales brochure, the mutual fund prospectus, is mainly impenetrable to investors. The SEC's own research (which I had more than a hand in designing) shows that while investors feel they absolutely must have the fund prospectus, they learn very little from it. This is not unsatisfactory to the mutual fund sponsors. Investors are somewhat baffled by investments generally and by mutual funds in particular, and as the SEC survey of fund investors demonstrated, are indeed poorly informed about them. It is certainly in the interest of both the ICI and the brokerage community to leave investors with the notion that investment decisions are very complex, and that one needs to be a professional in order to make wise choices. This attitude is well borne out in the ICI's position on risk disclosure for mutual funds. The capture is seen in the SEC's tepid response on the issues.

The controversy over fund risk disclosure has arisen from two important changes that have occurred over the last twenty years. First is the change in the demographics of responsibility for investment choices. As of 1980, only about ten percent of the households in the United States had ever directly purchased a security. Many people had large investments in defined benefit pension plans, whose assets were managed by their employers. By 1995, this figure had grown to 35 percent, almost entirely through the growth in mutual fund sales, and this mainly through defined contribution pension

vehicles (401Ks, Keoughs, IRAs, etc.) as defined contribution plans supplanted the traditional corporate defined benefit pension plans. Some of the increase was also due to mutual fund sales through banks.

This important change in the demographics of participation in the securities markets coincided with the introduction of “structured” securities. The first big wave of structuring in securities came quickly after the introduction of mortgage-backed securities. Securities which represented pools of mortgages, usually single-family residential mortgages, were separated into parts, with different parts sold to different investors. For example, a simple but representative structuring of a mortgage-backed security would be to assign the first half of the mortgage principal payments (including prepayments), along with accompanying interest to the date of prepayments—whenever they occurred—to one group, and the remaining half of the principal payments to a second group. These are known as prepayment *tranches*<sup>5</sup>. Another standard structuring is to divide the payments from a mortgage pool or a bond into just the interest payments, and just the principal payments, known as interest-only (IO) strips, and principle-only (PO) strips. By structuring a security, one can create sub-class securities that have either much less risk or much more risk than the underlying security.

Traditionally, words have been used to describe risk in mutual fund prospectuses.<sup>6</sup> To the degree that investors in mutual funds were the same people who were investors in stocks and bonds, and familiar with what a 20-year BB bond (for example) was, this was relatively satisfactory. With the introduction of structured securities, information contained in simple words like “stock”, “bond”, and for bonds, maturity date and default risk rating, became much less communicative of how much risk was involved in a particular investment.

The introduction of structured securities thus stimulated organized objection to mere words for describing risk. The bond rating agencies, notably Standard and Poor’s, were concerned that their bond ratings, designed to indicate risk of default, were being misused to indicate overall risk by some mutual funds. For example, a mutual fund could

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<sup>5</sup> *Tranche* is the French for “slice”.

<sup>6</sup> A notable exception is the Vanguard complex, which has reported the standard deviation of return, normalized to a portfolio of half bonds and half stocks, for all of its funds for many years.

hold principal-only strips in long-term AAA-rated bonds, and advertise itself as a AAA bond fund with an exceptionally high yield, failing to emphasize that the interest rate risk in the fund was far greater than that of a AAA bond fund holding the better-known whole AAA bonds. Similarly, some bond funds were advertising themselves as “government-guaranteed” or “US Treasury” bond funds with exceptionally high yields, holding nothing but principal-only strips of 30-year US Treasury bonds. The government funds were not S&P’s particular problem, but as long as they were going to tackle mutual fund risk, they decided to tackle it all.

After considerable market research, S&P decided to attach letters like its default risk letters to mutual fund risk for the simple reason that it found investors paid little attention to anything else. When S&P experimented with numbers for fund risk, if any default risk letters, like AA or BB were also displayed, investors gave far greater weight to the letters. Only when overall mutual fund risk was reported *also with letters* did investors realize that AAA default risk could be accompanied by BB overall risk. Indeed, a portfolio of 10-year Treasury bonds would be assigned a BB overall mutual fund risk rating by the S&P method.

S&P’s method is, in the first and last analysis, a standard deviation approach. Standard deviation is a statistical measure<sup>7</sup> that indicates the dispersion of values of a variable with normal (bell-shaped) distribution. Even if applied crudely, this approach should be very successful. When standard deviations calculated on three years of monthly mutual fund returns are regressed on the standard deviations similarly calculated for the subsequent three year period, these cross-sectional regressions produce explained variation statistics ( $r^2$ ) of .80 to .90. Mutual fund risk, measured as standard deviation, is highly stable. In fact S&P’s approach is more sophisticated than this, as it is based on funds’ current portfolio holdings instead of simply past returns, and has “judgement” added. Just what “judgement” means is not so clear, but presumably it has been empirically evaluated to be at least as good as a simple projected standard deviation, which we already know is very good indeed. Moreover, S&P’s approach—the standard deviation approach—to mutual fund risk is essentially the same as that of the major investment banks in assessing their derivative positions (Value-at-Risk ©,etc.) and of the

options exchanges in evaluating their customers' risk exposure, and even the same as the approach of all of the financial economists who have been recent recipients of Nobel prizes in economics.

Now this sounds like a story that should promptly end happily: The demographics of the market changes, and the market itself becomes more complicated. A private, *free-market* solution, researched and refined for digestibility, is produced with alacrity. Problem solved.

This is not what has happened. In order for any materials to be given by brokers to investors, the NASD must approve these materials. This includes the S&P mutual fund risk ratings. In order to get its materials approved, S&P must apply to the NASD to change its rules. Twice S&P was turned down, on the basis that the risk ratings might mislead investors more than inform them. As of the third application, the materials were approved on an experimental basis, with the strict caveat that the risk ratings cannot be called risk ratings, but must be called *volatility* ratings. The NASD decision will then proceed to the SEC for its review, as all NASD rule changes must be approved by the SEC. The SEC will approve the rule, (the SEC must be given credit for pressuring the NASD into finally approving the ~~risk~~(-ahem) *volatility* ratings ) grumbling because the disclosure is not as informative as it could be, but will, I expect, take no action to improve it.

This skirmish over risk ratings takes place against a broader discussion of a more thorough revision of the basic prospectus, including the possibility of a one-page summary prospectus that could be printed as an advertisement and would suffice as the disclosure required for a sale. Presently, an investor must possess a prospectus before the fund can take legally her money. On the one hand, the fund sponsors face the possibility of substantial savings from the printing and mailing of prospectuses. The danger to the funds is that the more succinct prospectus, if it contained the most relevant information, might just reveal to investors what mutual funds do and do not have to offer them. This should give rise to a mighty wave of price competition in mutual funds as investors realize what they do and do not get for their annual expenses. I do not regard this as a

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<sup>7</sup> Formally, it is the square root of the average squared deviations from the mean of a variable.

threat to the size of the mutual fund business, but it certainly is a threat to its present nature.

Thirty years of research on mutual fund performance has told essentially the same story. From Jensen [1965] to Carhart [1997], basic results that emerge from this research are that

- The average fund does just a little bit worse than the market.
- The more of investors' money funds spend on "research" and trading, the more they do worse than the market, and
- There is no serial correlation in fund performance.<sup>8</sup>

This does not imply that mutual funds are a bad deal for investors. On the contrary, they can provide thorough diversification an improved risk-return tradeoff even for small investments at a low price. They can deliver substantial savings in transaction costs. But their advertising is almost entirely in terms of *performance*, a quality that the research says they cannot deliver.

Could a one-page prospectus provide what investors need to know about a mutual fund in order to evaluate it? In principle, unquestionably yes. The main evidence of this is that the Morningstar one-page fund summaries contain every fact that most financial economists would regard as relevant to mutual fund investment decisions (plus a lot of information that is not relevant, or is at least redundant). But the format of the Morningstar summary is very challenging for the ordinary investor. Indeed, the aspect of it most salient to the ordinary investor is the Morningstar "star" ratings, which indicate, by assigning between one and five stars, the past performance of the fund compared to similar funds. To resist the implication that this performance ranking will persist is very difficult for most people. Yet the scientific research indicates that there is no serial correlation in fund performance, and even Morningstar's founder and leader Don Phillips

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<sup>8</sup> A small caveat is needed here: Funds among the very worst performers (lowest 2 -3 %) are more likely to be among them next year than other funds.

will emphasize that its stars do not predict fund performance.<sup>9</sup> The stars should be ignored.

Here is a case where the optimistic “public interest” view of government action could be very helpful. There are certain pieces of information about mutual funds that are essential, such as risk, return, and expenses and load fees. (Tax basis, taxable ordinary income and capital gains, and logistic details such as minimum initial and additional investment, checkwriting, etc, are also essential but deserve less emphasis). A standardized format for reporting them would help investors not only to assess a given fund, but through use would teach them to understand their investments better as they became familiar with the format. The notion of externalities essential to efficient government action is indeed present here: information is valuable to everyone, its marginal cost is essentially zero, and a standardized format for all funds makes them all easier to comprehend. This is the philosophy behind the FTC’s standardized disclosure on appliance efficiency, and the FDA’s nutrition label for packaged food.

What is the difference between the securities industry and the food industry that we have a clear, standardized nutrition label, but still struggle with the impenetrable, and often indeed, not meaningful, mutual fund prospectus?

Perhaps part of the answer lies in the absence of a competing regulator. The Department of Commerce is generally regarded as the province of corporations, representing them in opposition to the Department of Labor. The Department of State has numerous small offices of experts in the affairs of other nations, largely representing the interests of these nations, and is poised in opposition to the Department of Defense, which represents the interests of the domestic defense establishment. The Department of Agriculture represents the interests of farmers and food manufacturers, often opposing the Food and Drug Administration, which represents consumer interests. We might expect more balanced and efficient rulemaking with competing agencies. Instead at the

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<sup>9</sup> Investors disbelieve this to such a degree that the NASD pressured Morningstar to produce star ratings based on one year of performance, when it had been producing only three, five, and ten year stars. Morningstar resisted, and its head, Don Phillips, flatly stated that the one-year stars would be meaningless. Under the threat of removing Morningstar’s NASD blessing as material that could be given to investors, Morningstar relented and produced a one-year star to help brokers encourage investors to churn their mutual funds.

SEC we have the Commissioners themselves taking into account the interests of the investing public to some degree, but also under considerable pressure from the regulatees, and the Commission staffs captured by the regulatees.

Part of the difference may also lie in the complexity of securities institutions. Most people, even without studying nutrition, have a good idea that fruits and vegetables are healthy foods and that butter and ice cream are not. Packaged foods are more of a mystery, and hence the need for the nutrition label. But everyone recognized the desirability of such a label.

But how many people realize that simple facts (performance, risk, expenses) about mutual funds can be usefully and simply summarized? How many people know the three basic results (reported above) about mutual funds? According to the SEC survey of fund investors, almost none. A simpler standardized disclosure would help them. But the prevailing forces at the SEC, forces of regulatory capture, have prevented it from happening.

#### **IV. The Division of Corporate Finance**

The division of the SEC that approves prospectuses for new securities issued and regular disclosures for companies with publicly traded stock is not captured by the companies who issue securities, its direct regulatees. Instead, it is captured by the lawyers who prepare their disclosures and the underwriters who take them public. This capture is easy to understand. The lawyers and underwriters are far less numerous than the issuers, and since they are involved in offerings every day, rather just from time to time (as are the issuers) they are far better informed as well.

The 1933 Act bar prefers that the regulations for disclosure remain complex, obscure, and in flux. Because the regulations are complex, the barrier to entry is high. Because the regulations are obscure, every issuer needs a lawyer who is familiar to the staff of the Division and can interact with them to get the client's materials approved. The rules are sufficiently unclear that it is very seldom that the Division reviews a filing and requests no changes. And because the rules are in flux, only those who practice regularly are qualified to do the work, providing another barrier to entry.

The situation in this division is the most stable of the SEC rule writing divisions. There are no exciting stories as with Market Regulation and Investment Management. Instead we have just a quiet hum of rent-seeking. No demographic or technological changes have altered the issues or the politics facing the division. Though this Division oversees prospectuses and other disclosures, investor protection never relied on investors actually reading and understanding these documents. Instead, class action lawyers and security analysts read the prospectuses. The information in them is promptly reflected in prices, and if it is found to be “wrong”, suits are promptly filed. When issuers complained to Congress that the suits are too numerous and too costly, Congress obliged with the Securities Litigation Reform Act of 1996. This Act seems to have had little impact on the frequency of disclosure-related suits. There is, however, a potential force on the horizon that could disrupt the capture and bring restive demands for change: stock offerings through the Internet.

## **V. Final Thoughts**

Despite the various complaints here regarding SEC decision making, I must join the rest of the world in acknowledging that the securities markets of the United States have been dazzling in their effectiveness at raising capital and supporting in the creation of value. But it is very difficult to know *why* they are so successful. Has the regulatory apparatus of the securities markets contributed to their integrity, and thus to their success? Or is the apparatus itself just another manifestation of the underlying commercial ethics that support such a great volume of mutually beneficial transactions? It is very difficult to know.

As I and other economists promote regulatory capture at the SEC (or elsewhere) to explain the outcomes of the regulatory process, I (we all) do so with a clear view of what the superior public choice outcomes would be. Thus, this paper is not as cynical as it first may seem. As much as the capture view explains the regrettable choices of regulating agencies, it also identifies opportunities for improved outcomes. Anyone who raises her voice as a cynical capture theorist is at heart an advocate for reform.