

**Regulating financial markets: Protecting us from ourselves  
and others**

Meir Statman  
Glenn Klimek Professor of Finance  
Santa Clara University  
mstatman@scu.edu

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### **Abstract**

The global financial and economic crisis of the late 2000s highlights the ongoing tug-of-war between those who pull toward free markets and those who pull toward strict regulation of markets. It also highlights the sometimes parallel and sometimes perpendicular tug-of-war between those who pull toward libertarianism and those who pull toward paternalism. Rising stock markets and economic prosperity add power to those who pull toward free markets and libertarianism, and stock market crashes and economic recessions add power to those who pull toward strict regulation and paternalism. I discuss the crisis of the late 2000s against the backdrop of earlier crises with special focus on margin regulations which limit leverage, suitability regulations which require providers of financial products to act in the interests of their clients, Blue Sky laws which prohibit securities deemed overly risky or unfair, and mandatory disclosure regulations which require providers of financial products to disclose pertinent information even if potential buyers do not ask for it.

## **Regulating financial markets: Protecting us from ourselves and others**

Any doubts that financial markets are global and that actions by one institution can bring down others were surely dispelled in the still unfolding financial crisis of the late 2000s. Any doubts that financial markets are built on confidence and trust were dispelled as well. The crisis brought the demise of Lehman Brothers, the government rescue of Fannie Mae, Freddie Mac and AIG, and the disappearance of Bear Stearns, Merrill Lynch, and Wachovia as independent companies. The bankruptcy of Lehman Brothers slashed the assets of the Reserve Primary Fund, the oldest money market fund, forcing it to break-the-buck and shaking confidence and trust in all money market funds. Central banks in the U.S., U.K., Europe and China reduced interest rates in early October 2008 in an attempt to bolster lending and reassure investors, but these reductions failed to halt the global slide in stock prices. “Lower interest rates reduce the cost of borrowing for banks, businesses and households, and potentially boost confidence,” wrote Hilsenrath, Perry and Reddy (2008). But “it’s far from clear whether the lower rates will make banks and other lenders, which are gripped by fear of defaults by borrowers, any more willing to lend.”

The financial crisis of the late 2000s renews the debate about the roles of governments and markets in promoting confidence, trust, and the economic gains they bring. And it renews the debate about the roles of governments and markets in protecting investors from themselves and from one another. Should government regulations lean toward libertarianism, freeing consenting adults to buy and sell as they wish, or should government regulation tilt toward paternalism, constraining the choices of even consenting adults to protect them from themselves, protect them from others, and protect the rest of us

from them? Should the government protect home buyers from the cognitive errors and emotions that lead them to sign mortgage documents before reading them because the stack of documents is too high and the emotional pull of home ownership is too strong? Steve Sanders (2007), a mortgage banker, noted that signing mortgage documents would have taken a day and one half if signers were actually reading the documents before signing them. “After witnessing literally thousands of signings,” he wrote, “I will tell you that most people are so focused on getting into their new home that they have no idea what it was they just signed.” And should the government protect us, the neighbors of foolish and emotional homeowners, from the consequences of their likely defaults and foreclosures? Should the government prohibit banks from issuing what it deems to be unsafe mortgages as the Department of Agriculture prohibits meat processors from selling what it deems to be contaminated meat and the Food and Drug Administration prohibit pharmaceutical from selling what it deems to be ineffective drugs?

Should the government protect financial engineers from the cognitive errors that lead them to faulty models? “To confuse the model with the world is to embrace a future disaster driven by the belief that humans obey mathematical rules,” said Emanuel Derman, a former managing director of Goldman Sachs to Lohr (2008). “Complexity, transparency, liquidity and leverage have all played a huge role in this crisis,” added Leslie Rahl, president of Capital Market Risk Advisors “And these are things that are not generally modeled as a quantifiable risk.” Should the government protect investors from the consequences of actions by financial engineers by, for example, regulating leverage which magnifies the consequences of erroneous models? And should the government intervene

directly in companies, bailing out banks and automobile companies with taxpayers' money and assuming ownership stakes in them?

Governments' regulations constrain otherwise free markets, and direct intervention pushes us even further away from free markets. Changes in regulations and interventions over time reveal continuing attempts by society, through its legislative process, to find the right spot in a tug-of-war between those who pull toward the free-markets end and those who pull toward the regulated markets and direct intervention end. At the extreme left are those who pull toward completely regulated markets and comprehensive paternalism, and at the extreme right are those who pull toward completely free markets and comprehensive libertarianism. But members of each group do not fully agree about how to pull the tug-of-war rope and how far to pull it. Only few want to pull the tug-of-war rope all the way to the left where most enterprises are owned by the government and regulations proscribe most transactions. And only few want to pull the rope all the way to the right, leaving no role for government. Instead, the tug-of-war is fought mostly in the middle, where groups pull left or right but not all the way to the left and right extremes. Those pulling toward regulations want regulations they consider helpful and effective, say mandatory disclosure of information about mortgages, but not regulations they consider excessive, say prohibition of some mortgages. Those pulling toward free markets want markets to be helpful and productive, say a free market in derivatives, but not necessarily a free market in cocaine.

Members of each group, motivated by ideology or self-interest, try to enlist legislators and the general public into their groups. Historical accidents, such as stock

market crashes and economic recessions, attract members to one group or another, boosting its power and tugging the rope left or right. New self-interest groups form once new regulations are enacted, new historical accidents occur, and the tug-of-war continues. This was true when the Securities Act of 1933, the Securities Exchange Act of 1934, and the Glass-Steagall Act of 1933 were enacted during the Great Depression, when the Gramm-Leach-Bliley Act was signed into law during the boom of 1999, repealing portions of the Glass-Steagall Act, when SOX was enacted after the 2000 crash, and most recently when financial institutions were bailed out and their regulation tightened in the late 2000s crisis.

The tug-of-war has been fought for centuries. In 1900, Charles R. Flint, the organizer of the United States Rubber Company, spoke for free markets and libertarianism and against regulated markets and paternalism. "My idea," he said, "is that affairs of trade are best regulated by natural law. The careless banker has lost his reputation; the careless investor has lost his money; and the result of it is, more care will be taken."<sup>1</sup> However, others were unwilling to leave the protection of the investor to the libertarian "natural law" of the marketplace and recommended paternalistic Blue Sky laws instead.

The price of Kansas farmland more than doubled from 1900 to 1910 and the new prosperity attracted investment promoters. Bateman (1973) quoted a commentator at the time: "The state of Kansas, most wonderfully prolific and rich in farming products, had a large proportion of agriculturists not versed in ordinary business methods. The State was the happy hunting ground of promoters of fraudulent enterprises; in fact, their frauds

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<sup>1</sup> (Carosso 1970, p. 160)

became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as the blue-sky merchants and the legislation intended to prevent their frauds was called Blue Sky Law.” (p. 766)

The state of Kansas enacted its blue sky law in 1910 and by 1933 every state except Nevada had a blue-sky law. Blue sky laws generally restricted underwriting commissions and the issuance of cheap stock, options and warrants to promoters, officers and employees. They also prohibited offering shares to the public at prices regulators deemed excessive.

Blue sky laws have changed much during the intervening decades, the result of a tug-of-war between those who want to make them more stringent and those who want to abolish them altogether. Sosin and Fein (1987) described amendments which weakened Illinois’ blue sky law in 1983. “The amendments were proposed by the non-partisan Securities Advisory Committee to Jim Edgar, secretary of state of Illinois, to address long-standing objections of the legal and financial communities that [the blue sky law] stifled capital formation, deterred private investment and resulted in gross inequities in the operation of the exemption from registration most frequently used in Illinois for limited offerings.”

Shefrin and Statman (1992, 1993) described the tug-of-war and its reflection in six regulations, blue sky regulations, mandatory disclosure regulations, margin (leverage) regulations, suitability regulations, trading halts, and insider trading regulations. My aim here is to discuss the tug-of-war within the context of the late 2000s crisis. Four of the six

regulations are especially pertinent, margin (leverage) regulations, suitability regulations, blue sky regulations, and mandatory disclosure regulations.

### **Margin (leverage) regulations**

There would have been no late 2000s crisis if not for leverage. There would have been no housing defaults and foreclosures if homebuyers paid for their houses in full with their own cash rather than leverage their houses through mortgage loans to the tune of 80, 90 and or even 100 percent. There would have been no late 2000s crisis if financial institutions did not multiply mortgage leverage in securities backed by leveraged mortgages. But the costs of regulations prohibiting leverage altogether are enormous. Few would be able to buy houses if not for the ability to leverage their down payments through mortgage loans. The leverage debate is not about whether leverage should or should not be allowed but about whether leverage should be allowed without limit. Much of this debate has been conducted in the context of stocks, where leverage is discussed in the language of margins.

Margins on stocks are regulated by the Federal Reserve Board of Governors and the minimum margin set by the Board has been constant at 50 percent since 1974. Margin has been employed for many years before it was regulated by the government and it has always been accompanied by concern. Speculation facilitated by low margins is among the factors blamed for the panic of 1907 and the crash of 1929. As President Franklin Roosevelt wrote to Senator Duncan Fletcher on March 26, 1934: “The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the

artificial and unwarranted "boom" which has so much to do with the terrible conditions of the years following 1929.”

Two particular concerns underlie the drive to regulate margin and limit it, one about the damage investors can inflict on themselves, and one about the damage they can inflict on others. Limits on margin were deemed necessary to protect investors from the cognitive errors and imperfect self-control that lead them to speculation facilitated by margin. And limits on margin were deemed necessary to protect others from spillovers caused by investors using margin. The alleged spillovers include increased volatility and diversion of credit from productive investments to speculative activities.

Protection of investors from their own cognitive errors and imperfect self-control is reflected in a passage from the general analysis of the Senate version of the bill underlying the 1934 act (Report 792): “Margin transactions involve speculation in securities with borrowed money... The ease and celerity with which such a transaction is arranged, and the absence of any scrutiny by the broker of the personal credit of the borrower, encourage the purchase of securities by persons with insufficient resources to protect their accounts in the event of a decline in the value of the securities purchased. Many thoughtful persons have taken the view that the only way to correct the evils attendant upon stock market speculation is to abolish margin trading altogether. A Federal judge furnished this committee with instances from his long experience on the bench, indicating that a large proportion of business failures, embezzlements and even suicides in recent years were directly attributable to losses incurred in speculative transactions.”

The desire to prevent excess volatility by limiting margin is reflected in a 1934 Commerce Committee report which stated: “So far as possible, the aim should be to try to create a condition in which fluctuations in security values more nearly approximate fluctuations in the position of the enterprise itself and of general economic conditions – that is, tend to represent what is going on in the business and in our economic life rather than in mere speculative or "technical" conditions in the market. ...The real evil in this situation is that the resulting speculation affects the national economy.”<sup>2</sup>

Preventing diversion of credit from productive investments to speculative activities has been stressed in the House of Representatives as the most important goal of margin regulations. The House Report 1383 says: “The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry--to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained by far higher rates into security loans and the New York call market. Increasing margin...is the most direct and the most effective method of discouraging an abnormal attraction of funds into the stock market.”

Concerns about spillovers of leverage into financial markets and the economy did not seem valid before the crisis of the late 2000s. Studies of margin and volatility by Hsieh and Miller (1990), Moore (1966), and Officer (1973) failed to link the two, although Hardouvalis (1988) did find a link. And the claim that financial markets divert credit from

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<sup>2</sup> Ellenberger and Mahar 1973, Vol. 5, p. 5

productive investments to speculative activities does not seem logical since credit does not stay in financial markets. In “Swaps, Derivatives, and Systemic Risk,” Merton Miller (1997) dismissed concerns about systemic risk in security and credit markets, such as those expressed in 1992 by Richard Farrant, deputy head of banking supervision of the Bank of England and chairman of the Basle Supervisors Committee on Off-Balance Sheet Risk. Farrant argued that “Different markets are being tied more closely together, greatly increasing the potential for shocks in one market to be transferred to others in ways that are not fully understood.” However, Miller described swap transactions as benign, analogs of back-and-forth swaps of two \$25,000 cats for one \$50,000 dog by bored financial traders on a slow trading day. “There is, of course, a credit-risk element in swaps as there is with any system of forward contracts,” wrote Miller, “But if one party defaults, the counterparty loses only to the extent it has been ‘in the money’ on the deal. And even then, only if the counterparty could not net the deficiency against other deals in which it is out-of-the-money to the defaulter or against any collateral previously posted by the defaulter. It is hard not to be impressed with how effectively the swaps dealers have dealt with credit risk by creatively and ingeniously combining credit management practices from the interbank forward markets and from the clearinghouses of futures exchanges.” (pp. 35-36).

We do not know yet if the stock market volatility of the late 2000s is linked directly to leverage, but we do know that the concerns of Farrant about transfer of shocks from one market to others are valid and that leverage overwhelmed the ingenious credit management practices of institutions that seemed solid only months before they collapsed.

Leverage in stocks is limited by regulations which set minimum margin at 50 percent, but there are no such limitations on hedge fund, investment banks, proprietary desks, or anyone who is leveraging through derivatives. The leverage of some financial institutions before the crisis of the late 2000s exceeded 95 percent and the leverage of some homeowners approached 100 percent. The financial crisis of the late 2000s has shifted tug-of-war power from those who pull toward free markets and libertarianism to those who pull toward regulated markets and paternalism. Those pulling for regulated markets are attempting to use their newfound power to extend margin regulations to financial institutions and homeowners, beyond stocks, so as to protect them from their own cognitive errors and imperfect self-control, and protect the rest of us from them.

### **Suitability regulations**

‘Cheat me once, shame on you, cheat me twice, shame on me.’ Free markets and libertarian societies are not without restraint. We prefer to stay away not only from those who have cheated us but also from those who fail to nurture a reputation for honesty and fair dealing. This preference provides an incentive for honesty and fair dealing even in the absence of regulations mandating it.

Reputation can sustain trust in free markets. Jacob Schiff, an investment banker at the turn of the 20<sup>th</sup> Century, attributed the growth of investment banking at his time and the prominence of firms like his own to "the fact that they have been more honest than those who, thirty and twenty years ago, were among the leading banking firms. Not more honest, as construed in the literal sense of the word, but honest in their respect for the moral

obligation assumed toward those who entrusted their financial affairs to them, be it investing in the securities of corporate enterprises which these bankers brought before the public, or otherwise; more honest in keeping their own capital from becoming immobile, so that their credit and prestige should not be called into question during times of financial peril and uncertainty; more honest in the ways which, not taking alone into account the monetary pecuniary profit, are certain, in the long run, to determine position, credit, and prestige." (Carosso (1970) p.49)

Alan Greenspan, the former chairman of the Federal Reserve Bank, would have preferred to sustain trust with reputation, as Jacob Schiff did. Goodman (2008) quoted Greenspan saying, "In a market system based on trust, reputation has a significant economic value." But reputation did not sustain trust. Greenspan added, "I am therefore distressed at how far we have let concerns for reputation slip in recent years."

Regulations can replace trust when reputation slips. Regulations can also replace trust when being cheated once does not put us on guard against being cheated twice, or when even one instance of cheating is one too many, as when predatory lenders force borrowers into foreclosure or bankruptcy. Suitability regulations are such regulations. The Maloney Act of 1938 established the NASD (now FINRA) to formulate rules to prevent abuse in the sale of securities and protect investors and the public interest. The NASD Rules of Fair Practice required that before members the NASD recommend securities to customers they should have reasonable grounds for believing that their recommendation are suitable suitable for their customers' financial situation and needs.

Suitability regulations are paternalistic. They represent a shift away from the libertarian notion that suitability is in the customer's eyes to a paternalistic notion where suitability is in the eyes of a broker. Mundheim (1965) described the difference between the libertarian and paternalistic notions of suitability writing that: "Imposition of any suitability doctrine has a revolutionary flavor, because it shifts the responsibility for making inappropriate investment decisions from the customer to the broker-dealer. It does so in what seems to me the correct belief that disclosure requirements and practices alone have not been wholly effective in protecting the investor--including protecting him from his own greed." (pp. 449-50)

Roach (1978) illustrated the application of suitability regulations, quoting from SEC decisions finding that a broker violated suitability obligations. "Whether or not customers Z and E considered a purchase of the stock...a suitable investment is not the test for determining the propriety of applicants' conduct in the situation before us. The test is whether [the broker] fulfilled the obligation he assumed when he undertook to counsel the customers of making only such recommendations as would be consistent with the customer's financial situation and needs. The record shows that [he] knew all the facts necessary to enable him to realize that reasonable grounds for his recommendations did not exist. (p. 1126) Roach added that "Both the NASD and the Commission here suggest that suitability is an objective concept which the broker is obliged to observe regardless of a customer's wishes.... The NASD's statement that the customer's "own greed" may well have been their motivation reinforces the idea that the customer is not sovereign for suitability purposes." (p. 1126)

The recent experience of subprime borrowers and lenders has prompted Representative Bradley Miller of North Carolina to introduce a bill extending suitability regulations to mortgage loans. Under that bill, lenders could be sued for providing mortgages which are not suitable for the borrowing homeowners. The Mortgage Bankers Association is not happy with such attempts, preferring libertarian notions over paternalistic ones. Tedeschi (2006) quoted Kurt Pfotenhauer, the senior vice president for government affairs and public policy at the Mortgage Bankers Association, saying: “[W]e believe the consumer is the best one to determine the loan product that’s best for their individual circumstances.”

The self interest of finance professionals inclines them toward libertarianism and perhaps their temperaments incline them in the same direction as well. (See Statman (2004)). We should not be surprised by the aversion of the Mortgage Bankers Association to extending paternalistic suitability regulations to mortgages. Indeed some continue to advocate shifts away from paternalistic suitability regulations in the direction of libertarianism. Recently, Shadab (2008) argued that suitability regulations by which investors lacking substantial wealth are precluded from investing in hedge funds. Shadab wrote: “Limiting hedge funds only to the wealthy prevents financially sophisticated yet nonwealthy investors from using the funds to minimize losses and maximize the risk-adjusted returns of their investment portfolios. To more fully advance the regulatory goals of investor protection and capital formation, U.S. financial regulators should therefore enact reforms to permit retail investors to invest in hedge funds.” (p. 1)

### **Blue sky and mandatory disclosure**

Suitability regulations are paternalistic, an anathema to libertarians. Extreme libertarians would rather trade in a buyer-beware market, free of regulations, where people can buy anything they want from willing sellers, not even assured that sellers do not lie. Indeed, this is the market that Akerloff (1970) described as the market for ‘lemons.’ Prospective buyers of used cars expect sellers to lie, saying that their cars are cream-puffs when, in truth, they are lemons. Buyers beware in such markets, assuming that they are buying lemons and offering no more than lemon prices. Less extreme libertarians would rather trade in a voluntary-disclosure market where regulations prohibit sellers from lying as they answer buyer questions, but do not compel them to answer buyers’ questions or prompt buyers to ask pertinent questions. In such markets prospective borrowers can ask mortgage brokers any question they want about fees and kickbacks, but brokers need not answer buyers’ questions and brokers surely need not tell buyers that better mortgages are available elsewhere. Mandatory disclosure is one length of tug-of-war rope away from extreme buyer-beware- libertarianism and one length of rope closer to paternalism. Lenders in mandatory-disclosure markets are required by regulation to disclose interest rates to be paid on loans even if borrowers neglect to ask for them. Further on the rope toward paternalism are regulations that require disclosure in particular forms, such as the Annual Percentage Rate (APR) form. In the days before the Truth-in-Lending Act of 1968 lenders could describe a loan as a ‘six percent interest rate loan’ where six dollars are deducted from every \$100 when the loan is granted and \$100 is paid in equal installments of \$8.33 during the following 12 months. While such description is not an outright lie, it is misleading. The effective interest rate of this loan is more than double the stated six

percent. The Truth-in-Lending Act mandated disclosure of interest rates uniformly as Annual Percentage Rate (APR), making it easier for borrowers to compare loans. Suitability regulations are one length of tug-of-war rope further away from libertarianism toward paternalism, and blue sky laws are a length of rope further toward paternalism. The frameworks of blue sky and mandatory disclosure regulations competed in a tug-of-war for a foundation role in the 1933 Securities Act. Mandatory disclosure won then but the tug-of-war continues today.

While all states with the exception of Nevada adopted blue sky laws by 1933, their enforcement was lax in part because states found it difficult to coordinate enforcement. Bills to improve the enforcement of blue sky laws by turning them into a federal law were introduced into Congress, and Congressman Edward Dennison's 1920 bill was most prominent among them. Seligman (1982) wrote: "The Dennison bill would have plugged the largest loophole in the enforcement of state blue-sky laws by making it illegal for any person to use the mails or any of the facilities of interstate commerce to sell securities in any state until there had been compliance with the formalities of that state's blue-sky law." (p. 50). But Dennison's bill never reached the Senate's floor.

In 1933, soon after President Roosevelt's inauguration, Senator Huston Thompson took the leadership in crafting a new securities bill in the spirit of blue sky laws, but other senators pull away from it. Seligman quoted Congressman Sam Rayburn casting doubt on the ability of a government to exercise its paternalistic powers wisely:

"Do you believe that an administrative officer of the Government ought to be given that much power, as a general principle - to pass upon whether or not a man's business is

based on sound principles? It is mighty easy when you go to write a statute, if you want to delegate absolute authority; you can write that in a very short statute; but the question that this committee has got to determine is whether or not you want to give anybody that kind of authority. (p. 56)

Roosevelt pulled toward mandatory disclosure and away from blue sky because he shared Rayburn's view that mandatory disclosure is better but also because passage of a bill founded on mandatory disclosure would have been faster than passage of a bill founded on blue sky, and the 1933 Act embodies the spirit of mandatory disclosure. Roosevelt wrote: "The Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit. There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public. This proposal adds to the ancient rule of caveat emptor the further doctrine: "Let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence." (Congressional Record, 73<sup>rd</sup> Congress, 1st Session, March 29, 1933, pp. 937 and 954)

The tug-of-war between those who pull toward the paternalism of blue sky and those who pull toward the libertarianism of mandatory disclosure continues today. Pulling toward paternalism are Bar-Gill and Warren (2008) who noted that physical products,

including toasters, lawnmowers, meat and pharmaceuticals, are regulated for safety. They urged the creation of a new federal regulator who would have both the authority and incentives to prohibit unsafe mortgages and other credit products. Pulling toward libertarianism is former Senator Gramm. Lipton and Labaton (2008) wrote that Gramm, described by a fellow senator as a true dyed-in-the-wool-free-market guy, “led the effort to block measures curtailing deceptive or predatory lending, which was just beginning to result in a jump in home foreclosures that would undermine the financial markets.” Speaking with Gramm they found that he holds firm to his views today, unswayed by the late 2000s’ crisis. Standing in between are Thaler and Sunstein (2008) who advocate paternalistic libertarianism, rejecting bans of credit products some consider unsafe, but urging regulations mandating clear-format disclosure that would nudge people toward the best credit products. “Credit regulation raises immense challenges,” they wrote, “and there is a serious danger that, in light of the current crisis, government regulators will overreact. The fundamental line of defense should be improving market competition, not eliminating it. And to improve competition, transparency is the place to start. As Supreme Court Justice Louis Brandeis proclaimed in 1914, “Sunlight is the best disinfectant.” That statement is the best foundation for rethinking credit regulation.”

### **What should we do?**

Testifying before Congress on October 23<sup>rd</sup>, 2008, Alan Greenspan, the former chairman of the Federal Reserve Bank said “Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a

state of shocked disbelief.”<sup>3</sup> A housing bubble combined with subprime lending and leveraged financial instruments and institutions to bring on a crisis of a magnitude not seen since the Great Depression. All of us, like Greenspan, have to come to grips with the crisis and reconsider the spot we should aim for in the tug-of-war between libertarianism and paternalism, markets that are completely free and markets that are severely regulated, and government that intervenes to bail out companies and combat unemployment and government that leans back to let companies fail and leaves employment to companies left standing. President Bush reconsidered his free-market non-interventionist position. In the last press interview of his presidency on January 12, 2009 Bush said:

“Now, obviously, these are very difficult economic times...The question facing the president is not when the problem started, but what did you do about it when you recognized the problem? And I readily concede I chunked aside some of my free market principles when I was told by chief economic advisers that the situation we were facing could be worse than the Great Depression. So I've told some of my friends who've said -- you know, who have taken an ideological position on this issue, you know, "Why'd you do what you did?" I said, "Well, if you were sitting there and heard that the depression could be greater than the Great Depression, I hope you would act too," which I did.”

The Wall Street Journal is still pulling toward libertarianism or, at a minimum, paternalistic libertarianism. It celebrated Barack Obama’s appointment of Cass Sunstein to the position of Administrator of the Office of Information and Regulatory Affairs inside the White House. “Mr. Sunstein is no conservative,” wrote the Wall Street Journal, “far from it.” But it expressed hope that Sunstein would guide the Administration away from

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<sup>3</sup> Edmund Andrews, Greenspan concedes error in regulation, NYT, October 24, 2008

cracking “down on financial innovation for no better reason than because it seems like a popular reaction to the credit crisis.”

The Wall Street Journal is right to be wary of overreaction that would pull us too close to the extreme regulation end in the tug-of-war. But there is also a danger in not pulling far enough toward that end. We cannot be blind to the systemic risk cascading from free but unwise behavior by some of us to disastrous consequences inflicted on all of us. We know now that the actions of homeowners who overloaded themselves with mortgages inflicted major collateral damage. And we know now that so did actions of financial institutions who overloaded themselves with leveraged mortgage securities. As President Bush noted, the government has moved some way toward the regulation and direct intervention ends, and I think that these moves are wise.

Regulations are not all equally good and we must choose the best among them by comparing burdens to benefits, however imprecisely. There are benefits to increasing home ownership by increasing the availability of mortgages even to subprime borrowers. Brownstein (1999) noted that homeowners are more likely than renters to participate in their communities and the children of homeowners tend to perform better in school. Moreover, increased homeownership allows minority families who have accumulated far less wealth than whites to accumulate wealth and transmit it to future generations. Brownstein described the increased African American and Latino homeownership in the 1990s as one of the hidden success stories of the Clinton era, noting that Clinton enforced the Community Reinvestment Act designed to prevent ‘redlining,’ and requiring banks to serve their low-income communities. The roles of Fannie Mae and Freddie Mac in

encouraging subprime lending by relaxing loan criteria were central to the effort to increase home ownership.

Support for the expansion of mortgage lending to low-income borrowers extended beyond Democrats to Republicans as well. Republican Senator Gramm was persuaded to support such lending by his mother's story. Lipton and Labaton (2008) quoted Gramm saying "Some people look at subprime lending and see evil. I look at subprime lending and I see the American dream in action...My mother lived it as a result of a finance company making a mortgage loan that a bank would not make...What incredible exploitation..." he said sarcastically, "As a result of that loan, at a 50 percent premium, so far as I am aware, she was the first person in her family, from Adam and Eve, ever to own her own home." But now we know that while mortgages extended to subprime borrowers can fulfill the American dream, mortgages extended to homeowners who lack the income to support them impose nightmarish burdens on these homeowners and the rest of us.

Regulations prohibiting mortgages with low teaser rates are burdensome to some potential homeowners and they exclude others from homeownership, but the benefits of such regulations likely exceed their burdens. The same is true for regulations limiting home leverage by specifying that down payments be no less than 20 percent. Such regulations should be accompanied by policies that equalize government benefits to homeowners and renters so as to reduce the disadvantage imposed on those who must rent because they cannot afford to buy. Policies might include reductions in the tax benefits afforded to homeowners or subsidies afforded to renters.

I would also advocate the application of suitability regulations to mortgage brokers, bankers, and other providers of mortgages. Mandatory disclosure of mortgage facts, even if done in mandated formats that aid comprehension, is insufficient because it leaves lenders and borrowers in adversary positions. We can see the effect of these adversary positions in all credit markets, including the credit card and mortgage markets. The Truth-in-Lending Act mandates disclosure of interest rates in the Annual Percentage Rate (APR) format, and there is evidence that consumers are indeed using APR numbers in comparison shopping. But APR is not the total cost of a loan and interest payments are not the total revenue of lenders. Credit card companies circumvent the spirit of Truth-in-Lending by adding late fees, over-limit fees, and other fees which are disclosed, but not in ways that make them easy to find. Even clear disclosure of such fees is not likely to be sufficient. Credit card applicants might be confident in their ability to pay balances in full and on time, but credit card companies know that such confidence is commonly misplaced and that interest and late fees would generate greater revenues than applicants anticipate. Mortgage loans are different from credit card loans mostly by their much higher dollar amounts and the much greater damage they can inflict on borrowers and on the rest of us. Suitability regulations would require that lenders not only disclose clearly all information about credit products but also guide borrowers to suitable ones. The burdens of suitability regulations in the credit card market might be higher than their benefits, but the benefits of suitability regulations in the mortgage market likely exceed their burdens.

Last are regulations that limit leverage employed by financial institutions, from hedge funds to banks. (I would have added investment banks, but investment banks are

now extinct, victims of leverage.) The desire of financial institutions to maximize profits is no different than the desire of butchers, bakers, and candlestick makers. But while the benefits that butchers, bakers and candlestick makers bring to the rest of us are obvious, the benefits of some products and services of financial institutions are not. Consider a hedge fund engaged in a long-short strategy, selling relatively expensive German bonds and buying relatively cheap Italian bonds, using a 30-to-one leverage ratio. Hedge fund investors profit if indeed German bonds become cheaper and Italian bonds become more expensive. There are also benefits to us, non-hedge-fund investors. The long-short actions of the fund move the prices of both bonds closer to their 'correct' or 'efficient' prices, providing correct 'signals' to policy makers, corporations and individuals. But are long-short actions primary in moving prices to their correct levels, or are they only secondary to the more prosaic actions of investors, such as pension funds, which buy the cheap bonds and shun the expensive ones? I would venture that a regulation that limits leverage does more good than harm if high leverage, such as a 30-to one ratio, can bring a collapse of LTCM's magnitude or worse. Similarly, mortgages bring much good, helping homeowners, and bundled mortgages do much good by spreading risk. But I see little good and much harm in allowing financial institutions to leverage mortgages and other securities without limit.

## **Conclusion**

In 1999 Senator Gramm spearheaded the Gramm-Leach-Bliley Act which lightened regulation, repealing regulatory barriers erected by 1933 Glass-Steagall Act to reduce the

risk of economic catastrophes by separating commercial banks from investment banks. Senator Gramm is a Republican, but support for the Gramm-Leach-Bliley Act extended beyond his party. The Act was signed into law by President Clinton, a Democrat.

We should not be surprised to learn that the Gramm-Leach-Bliley Act was enacted in 1999, knowing that 1999 was at the top end of a financial and economic boom. Financial and economic booms shift tug-of-war power from those who pull toward paternalism and heavy regulation to those who pull for libertarianism and free or lightly regulated markets. Now, in a year at the bottom end of a financial and economic bust, power is shifting to those who pull toward paternalism and heavy regulation.

History tells that we tend to overreact, urging legislators and government executives to pull too far toward the paternalistic end when we are fearful and too far toward the libertarian end when we are exuberant. There is danger in pulling too far toward one end or the other, but there is also danger in not pulling far enough. The pull toward the libertarian and lightly regulated end stoked the stock bubble of the 1990s and the real estate bubble of the 2000s. Some urge us to stop pulling toward the paternalistic end once we have reached mandatory disclosure to investors and mandatory transparency in financial institutions and markets, often quoting Supreme Court Justice Louis Brandeis 1914 proclamation that the sunlight of disclosure is the best disinfectant. But today, almost a century after Brandeis' declaration, we know that our hospitals need more than sunshine as a disinfectant, and that diseases can spread rapidly even when only relatively few forego immunization. Mandatory disclosure might keep most of us economically healthy most of

the time, but we need the economic equivalent of mandatory immunization to prevent the carelessness of some from infecting us all.

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