

Speech by SEC Staff: The Future of Securities Regulation

by

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INTRODUCTION

Thank you very much for that very kind introduction. It's an honor to be a part of this program and to be asked to join the distinguished jurists who have previously spoken here. It's frankly humbling to have my name added to the list.

There's one formality I have to get out of the way right at the outset. I'm required by our rules at the SEC to remind you that the views I express today are my own and not necessarily those of the Securities and Exchange Commission, its Chairman, its Commissioners or any of my colleagues on the staff.

Those of us who work at the SEC are all required to recite that disclaimer whenever we speak publicly. Sometimes, of course, SEC speakers simply can't avoid communicating perspectives relevant to the current work of the agency. In this academic setting today, however, I have no such intent in mind. So I'm sorry to disappoint you if you've come in the hope of learning some useful intelligence about possible Commission policies or actions in the coming year. You won't be getting that today. Instead, we'll be taking a much longer-term view, looking back at trends that have been developing for decades in a effort to infer what may be ahead.

My topic is: "The Future of Securities Regulation." That topic easily could fill — to overflowing — an academic year of five lectures a week. So of course I'm going to have to be highly selective. In all candor, as you'll see, I'm going to be idiosyncratically selective as well.

I understand that not everyone here is expert in the field of securities regulation. So I'm going to try to avoid technicalities, even though we all understand the force of the old cliché that "the devil is in the details."

Even with these limitations, I'm hoping we can have a good deal of fun considering some interesting issues together during the next hour.

Oh, and there's one more thing. Anyone thinking about the future of securities regulation can't help but focus on the advance of technology and its close cousin, globalization. Technology and globalization are each a fascinating and rich source of countless topics worthy of inquiry and discussion in any consideration of the future of securities regulation. Technology and globalization would take up many months of that year-long series of

lectures I just envisioned. But, perhaps perversely, I'm going to ignore the obvious and direct our attention elsewhere.

But let's not tarry any longer. Let's plunge in.

DERETAIALIZATION

I'd like to start with the group of closely interrelated trends I call "deretailization."

Deretailization? I'm sure many of you — if not most of you — are thinking: "Deretailization? If that were a word — which it isn't — it would be a very ugly word."

Well, you're quite right, of course — on both counts. While preparing this lecture, I Googled "deretailization" and, as I half-expected, I got zero hits. That doesn't happen all that often with Google. If you Google "deretailization" tomorrow, though, you'll get at least one hit, because by then this lecture will have been posted on the SEC's website. Sorry about that!

Despite its somewhat awkward coinage, I believe the term "deretailization" nonetheless captures — and succinctly describes — trends that are no less important because they have been developing for some decades and are lying out in plain sight.

So what do I mean by "deretailization"? I mean to refer not only to the dwindling percentage of retail investors in some of our key existing markets, but also to the exclusion of retail investors entirely from some of the most important and dynamic new trading markets and new asset classes.¹

Deretailization has many aspects. Let me illustrate by pointing out some of the more important.

DERETAIALIZATION: DWINDLING STOCK OWNERSHIP PERCENTAGES

First, let's consider the direct ownership of shares of stock in public corporations. In the United States, retail investors own a much smaller percentage of publicly traded stock than they used to. Estimates vary, but widely cited sources put retail stock ownership in 1950 at more than 90%, while I've seen some estimates that put current retail ownership as low as a little over 30%. Other estimates aren't quite as low.

But for our purposes, the exact numbers don't matter. The point is simply that over the last half century direct stock ownership by U.S. retail investors has been in an on-going decline relative to ownership by institutions. Institutional ownership used to be almost irrelevant. Now, retail ownership seems to be headed in that direction.

This is a long-term trend, and it shows no sign of abating. If it continues, sooner or later the very roughly 90-10 relative importance of retail investors and institutions in the stock market of 1950 could even be reversed. But even if that doesn't happen — and I'm not here today to predict it will — deretailization of our stock market nonetheless will have, and already is having, profound consequences.

Retail investors of course remain *indirect* owners of stock. It's just that their ownership now is increasingly intermediated by mutual funds and other collective vehicles.

As recently as 1980, the SEC felt it necessary to adopt Rule 12b-1 to aid a mutual fund industry that was still struggling to get off the ground, despite its origins many decades earlier. But in the last quarter century, these financial intermediaries have taken off. Mutual fund AUM — assets under management — now exceeds \$10 trillion and continues to grow, and retail investors own the overwhelming majority of mutual fund shares: almost 90%. So retail investors continue to invest very large dollar amounts indirectly in stock and other public securities — but only indirectly.

This means that, increasingly, retail investors are not the ones deciding whether to buy, sell or hold individual stocks, or — and this is very important — how to vote them. When retail investors make investment decisions, those decisions now more often concern which intermediary to employ, not which stock to buy. And this has important consequences, some of which we'll talk about a bit later today.

DERETAILIZATION: INSTITUTIONS-ONLY TRADING MARKETS

The second form of deretailization I want to discuss is the development and growth over the last several decades of important new trading markets that are entirely closed to retail investors. The "dark pools" of liquidity that have garnered some press of late are one example, but perhaps the most familiar is the 144A debt market.

Promulgated by the SEC in 1990, Rule 144A removed most of the regulatory impediments to secondary market transactions between large institutions that qualify as "QIBs." "QIB" or "Q-I-B" is the acronym for "qualified institutional buyer," a term defined in Rule 144A generally to mean institutions that have at least \$100 million invested in securities.

Rule 144A created an efficient QIB-only secondary market. After Rule 144A was promulgated, investment bankers quickly discovered the advantages of selling only to QIBs in debt offerings. The liquidity of the new 144A trading market turned out to be sufficiently high that the initial buyers did not exact an illiquidity "haircut" in price relative to what they would have been willing to pay had the securities been registered with the SEC first so that retail investors could be included in the pool of potential buyers.

From the point of view of the company issuing the debt, this meant there no longer was any incentive to pay the cost and, perhaps more important, risk the delay, of the SEC registration process, which can take many uncertain months to complete. So the 144A market became a very big market. The amount of debt issued in the 144A market today very much varies with market conditions, but typically amounts to hundreds of billions of dollars annually. What's important for us in our discussion today is that, by definition, this is an institutions-only market, without retail participation.²

Until now, the 144A market has been restricted mostly to debt and not much used for equity. When equity is being sold, the incremental advantage of the capital and liquidity provided by retail investors has outweighed the additional costs and burdens of their presence — at least so far.

But this may be changing. Within only the last year or so, at least five platforms that would provide institutions-only trading markets for common stock — markets that would in effect compete for IPOs directly with the public stock markets — have been announced or deployed. As has been reported in the press, Goldman Sachs, Bear Stearns, JP Morgan Chase and Nasdaq each now have such an offering of their own, and eight other major financial institutions (Bank of America, Citigroup, Credit Suisse, Bank of New York Mellon,

Lehman Brothers, Merrill Lynch, Morgan Stanley and UBS) have joined together in a consortium to form another platform in this space.

It is still far too early to know whether these efforts will capture only a niche market or have broader appeal, but these major financial institutions evidently believe it's worth exploring the possibilities. This could be a development to watch. And, if the additional capital and liquidity contributed by retail investors in the public markets continues to dwindle in the coming years, it's natural to expect that institutions-only trading markets could become increasingly prominent, even dominant, given the added compliance costs and litigation risks retail investors bring with them — costs and risks that don't end when the securities are issued, but are on-going as long as the securities held by retail investors remain outstanding.

So far we've talked about two forms of deretailization: the shrinking percentage of direct retail investors in the stock market and the development of institutions-only trading markets that exclude retail investors entirely.

DERETAIALIZATION: INSTITUTIONS-ONLY ASSET CLASSES

Yet a third form of deretailization is the development of new and dynamic asset classes that also exclude retail investors entirely. This form of deretailization also represents a decades-long trend.

Let's start with venture capital. Venture capital funds came into their own in the 1960s after the seminal funding of Fairchild Semiconductor by Venrock Associates in 1959. With few exceptions, such as the occasional "friends and family" or employee investor, retail investors are excluded from investing in venture capital funds. Venture capital funds, however, have become indispensable as one of the most important drivers of innovation and growth in our economy and as an important — and high return — asset class for institutional investors.

Similarly, private equity funds, which came into their own in the late 1970s and 1980s, also generally have been closed to retail investors. Private equity funds represent another important — and high return — asset class for institutional investors. Retail participation, however, has been unwelcome — some very recent, and perhaps isolated, exceptions to the contrary notwithstanding.

Private equity funds in fact triply compound deretailization, in that — one — not only can retail investors generally not invest in them, but — two — the very purpose of private equity funds is to buy out the retail investors in previously public companies, and — three — those buy-outs typically are financed in institutions-only 144A and syndicated secured debt markets.

It's been 18 years since Michael Jensen published "The Eclipse of the Public Corporation" in the Harvard Business Review, arguing that private equity funds offer better management than public ownership does. Nonetheless, so far at least, many, if not most, companies taken private in LBOs have eventually returned to the public company universe by way of a public IPO. This cycle is not a law of nature, however, and could be altered by the trends we already have identified: deretailization in the public stock market and the development of competing institutions-only trading markets.

The list of asset classes highly prized by institutional investors but from which retail investors are excluded doesn't end with venture capital and private equity. Hedge funds, now much in the news, also exclude direct retail investors.

As everybody knows by now, the term "hedge fund" is not really descriptive, but just refers to a private pool of institutional capital. Many hedge funds, in fact, invest in the same universe of securities as do mutual funds, albeit with a potentially broader range of strategies and techniques. So hedge funds can be thought of as actively managed mutual funds for institutional investors.

And hedge funds have proved to be a magnet for institutional investors. Assets under management by hedge funds have been growing dramatically and now are estimated to exceed \$2 trillion. So hedge funds are yet another important — and high return — asset class just for institutional investors.

In sum, viewed from different perspectives, we see the relative role of the direct retail investor shrinking in some of our key domestic markets. Accounting for more than 90% of stock ownership in 1950, the retail investor now represents maybe as little as something like a third of that, and the percentage is falling. New markets for secondary trading, such as the 144A market, are springing up that are designed to exclude the retail investor and the burdens that come with him or her. And, over the last few decades, new intermediary vehicles — venture capital funds, private equity funds and hedge funds — have been developed and are prospering. These new asset classes occupy an increasingly important part of the investment landscape and represent much of its dynamism, but they all exclude retail investors.

We're here today at a university. University endowments provide a telling example of the impact of deretailization. In the 1950s, the securities portfolios of these endowments comprised almost exclusively publicly traded debt and equity securities also available to retail investors. Now, however, these endowments are devoting an ever-increasing share of their securities portfolios to so-called "alternative investments," which almost always are asset classes open only to institutions.

The best managed of these endowments provide annual returns most retail investors could only dream of. Exceptional professional management undoubtedly is part of the reason for these returns. But part of the reason also is access to the more attractive new asset classes and vehicles, from which retail investors are excluded. Not only are these asset classes high-return, but their risks often are sufficiently uncorrelated with each other or with other asset classes so their presence substantially increases the expected portfolio return without unduly increasing overall portfolio risk.

Most retail investors, however, simply cannot assemble a portfolio with the desirable diversification and return characteristics available to institutional investors.

WHAT'S CAUSING DERETAILIZATION?

So it's important to ask: what's causing deretailization? There are two key drivers.

First, back in 1950, when retail investors represented 90+% of the direct investment in our stock markets, investing was a much simpler proposition. Apart from the opportunity to devote greater time and attention to the effort, professional money managers did not have

obvious advantages over the do-it-yourselfer. That's no longer the case, and individual investors intuit the difference. Our understanding of markets has become far more sophisticated and mathematical over the ensuing decades. The amateur plays at a disadvantage. So retail investors have simply acted rationally in choosing to turn their portfolios over to professionals, typically by employing intermediary vehicles such as mutual funds. This is only sensible, and certainly not a trend one should wish to reverse.

ANTIFRAUD-ONLY VERSUS RETAIL-PROTECTIVE REGIMES

That's what's driving deretailization from the retail investor's side of the equation. Now let's consider the other side of the equation and see what's driving the development of new markets and new asset classes that exclude retail investors.

We, and most other jurisdictions, have two principal modes of securities regulation that live side-by-side and, in effect, compete with one another. We have a mode that one might call "antifraud only" for those markets that exclude retail investors. And we have a mode that one might call "retail protective" for those markets that permit retail investors.

In the antifraud-only mode, the authorities generally are not involved unless and until a fraud occurs. In antifraud-only regimes, market participants generally are not required to register their personnel, their entities or their transactions with the government, they are not required to file statements or reports with the government, they are not subject to examination or inspection by the government, and government rules do not specify how they should conduct their operations, what they cannot do or how they can be compensated. Only if there has been fraud, do the authorities step in after the fact.

In addition, as a practical matter, the risk of private litigation is low, in part because institutional investors often agree by contract to hold their managers liable only for willful misconduct or gross negligence, and in part because any institution perceived in the marketplace to be too quick to bring a legal action could find itself excluded from future attractive investment opportunities.

In the retail-protective mode, by contrast, market participants are subject to pervasive regulation. For example, contrast hedge funds — the vehicle of choice for many institutional investors — with mutual funds — the vehicle available to retail investors. Mutual funds are subject to the full panoply of retail-protective regulation. The company that manages a mutual fund, the company that distributes the mutual fund shares and the mutual fund itself all must register with the government. All three are subject to extensive examinations and inspections by the government. Mutual funds must file extensive registration statements and reports with the government. And rules and regulations tell mutual funds how they can, and cannot, conduct their operations. Among other things, these regulations impede or render impossible a variety of investment strategies and compensation arrangements.

Hedge funds, by contrast, suffer none of these burdens. Nor do venture capital funds or private equity funds.

Imagine you are a talented money manager with the ability to outperform the competition by investing in the public markets, by investing in start-up companies or by buying mature companies. Imagine further that the highly sophisticated professionals who manage money for institutional investors recognize your ability, so they are prepared to permit you to

manage their money. Why wouldn't you choose to form an institutions-only investment vehicle subject to the antifraud-only regulatory regime?

Well, you might not if the incremental advantage of the capital and liquidity provided by retail investors outweighed the additional costs and burdens their presence imposes. Evidently, however, that generally must not be the case for venture capital, private equity, hedge funds, the 144A market and others.

Quite obviously, this does *not* mean that we should dismantle or cut back on the retail-protective regimes. Institutional investors have economies of scale retail investors lack. If you're contemplating an investment of tens of millions, you can afford rigorous professional analysis and due diligence. If you're investing tens of thousands, you can't. So retail investors require a regulatory regime that can serve as a substitute. And that's not going to change.

Nor would it make sense to foist the costs and burdens of retail-protective regimes on institutional investors who neither want nor need them.

But now that the defined benefit plan is an endangered species, retail investors increasingly are managing their own pensions. Their inability to obtain the same desirable diversification and return characteristics that institutional portfolios can is a challenge that demands our attention. Some university endowments now seek to attract high net worth donors by offering them side-by-side participation in the endowment's investments. We may need to start considering whether there are better solutions — and more broadly available solutions — than that.

INSTITUTIONALIZATION

Now that we've examined the deretailization phenomenon, I'd like to use the balance of this lecture to discuss some of its consequences. Let's start with institutionalization.

Institutionalization of course is the flip side of deretailization. If direct investment by retail investors is declining, the role of institutional investors is correspondingly growing. As it seems likely this trend will continue, we need to focus on who these institutions are and what new issues their increasing dominance presents.

Institutionalization presents at least two principal challenges. The first results from the increased concentration of ownership in the hands of fewer and fewer institutions, some of which may not have purely economic motivations. The second results from the need to provide retail investors who increasingly invest only through intermediaries with the necessary tools and protections to do so more wisely.

OWNERSHIP BY THE FEW

Let's consider these in turn. We start with concentration.

With deretailization comes increasing concentration of ownership. We typically imagine our major markets as comprising innumerable atomic participants, each too small to have meaningful individual influence. We imagine ownership to be widely dispersed, and the action of the market to be the product of the wisdom of almost countless anonymous

decision makers. But even today, that's no longer entirely so. And if current trends continue, it will be even less so in the future.

Reflecting deretailization, I've seen estimates that America's 100 largest money managers together now hold something like 60% of all stocks. Once again, the precise numbers are unimportant: only the general order of magnitude matters.

But, think about what that means: Suppose you could get a decision maker with authority from each of those money managers to attend a meeting. You would not need a very big room — you could book the smallest seminar room at the hotel. Ten rows of ten seats each would suffice. And with their 60% stake in the entire public company universe, those 100 decision makers could, especially if they chose to act together, wield remarkable influence over all our lives.

We need to begin focusing on who those 100 decision makers are, especially if they might act in concert or in conscious parallelism. If essentially all our public corporations, the engines of our economy, may be influenced or controlled by a small roomful of people, it's time to take a close look at who they are and what motivates them.

Increasingly, we need to ask questions like:

- What safeguards assure that the managers of these intermediary institutions are not executing their own non-economic agendas driven by motivations unrelated either to the best interests of those whose assets they manage or to the best interests of the economy and the citizens of the nation at large?
- To what level of accountability and transparency are they subject or should they be subject?
- To whom are they beholden?

In short, we may need to start worrying not only about the governance of the companies in the Dow Jones Wilshire 5000, but increasingly about the governance and collaboration of the largest 100 institutional owners who increasingly will influence and control the Dow Jones Wilshire 5000. This will be especially true if the governance or other characteristics of any significant number of those 100 top institutional owners suggest they may have motivations beyond wealth maximization alone.

SOVEREIGN WEALTH FUNDS

As just one example, I'd like to focus on a class of institutional investors we should suspect might have non-economic motivations: sovereign wealth funds.

Sovereign wealth funds are just beginning to attract public attention. And well they should. What is a sovereign wealth fund? A sovereign wealth fund is a pool of capital controlled by a government. Governments obtain these funds in a variety of ways. In many cases, the funds are petrodollars accumulated from the sale of oil. In some cases, they are simply central bank reserve holdings.

Current estimates vary but suggest that sovereign wealth funds today probably total somewhere around \$2 to \$3 trillion. That's about the same — or actually a little more —

than currently is held in the aggregate by hedge funds. And sovereign wealth fund holdings are increasing rapidly. Knowledgeable observers have estimated that by 2015 sovereign wealth funds will have grown to about \$12 trillion in assets.

That's serious money. And that's before including their close cousins, the state-controlled enterprises.

Think of sovereign wealth funds this way.

- Suppose our government, the U.S. government, announced that it had invested billions in a major U.S.-based private equity firm.
- Or suppose our government, the U.S. government, announced that it had acquired a leading proxy voting advisory firm.
- Or suppose our government, the U.S. government, announced that it was seeking to take a significant position in a major U.S. securities exchange.

Perhaps there are a few in the crowd who would cheer. But my guess is most of you would have some reservations. And, I think, rightly so.

In fact, of course, through sovereign wealth funds and state-controlled enterprises *foreign* governments are doing everything I just mentioned. The trouble, of course, is that governments can be counted upon to act out of more than just economic motivations. It's in their DNA. And that's a potential problem.

It's a potential problem, even if it's your own government. It's a much bigger potential problem, I think, if it's somebody else's government, because then you have to compound already serious concerns about diminished economic efficiency and suboptimal allocation of resources with foreign policy and national security concerns.

The danger is that it's too easy to conflate investment by foreign *private* interests with investment by foreign *governmental* interests. The two are very different, just as investment by a U.S. private enterprise is very different from an investment by an entity controlled by the U.S. federal government or a state government. One can cheer foreign direct *private* investment, while at the same time having real concerns about foreign direct *governmental* investment.

At the present time, the G7 nations and the President's Working Group on Capital Markets, among others, are considering some of these issues. And Chairman Cox is delivering a lecture just today at another university focused on this same topic. His remarks will be on our website, and I commend them to you.

Sovereign wealth funds and their cousins, the state-controlled enterprises, are one example of a class of institutional owners whose behavior can be expected to reflect, in part, non-economic motivations. Any other class of institutional investors that has objectives beyond maximizing financial returns would pose similar issues.

Before deretailization took hold with a vengeance, we could rely on the workings of a market comprising countless atomic actors to shield us from the distorting effects of non-economic motivations. With the trend toward deretailization and institutionalization, we will

need to shift our attention to this new level, to ensure that our economy, and the individual citizens who participate in it, continue to benefit from the dynamism we have enjoyed for so long.

HELPING RETAIL INVESTORS MAKE BETTER CHOICES: THE NEW FRONTIER

Now let's change gears again and consider the consequences of deretailization from yet another perspective. If the investment choice most important to retail investors increasingly is not which stock or bond to buy, but which fund (or other intermediary) to choose, then we should be seeking to ensure that retail investors have the right tools to make that choice wisely.

This should be the new frontier in regulatory policy.

Why do I use a term like "new frontier"? Because this is an area in which I believe the most recent developments in the theory of finance, including behavioral finance, have yet to be applied.

Advances in the theory of finance have affected securities markets and securities regulation over the last several decades just as much as have computers, the internet and globalization. Take, for example, the publication in 1973 of "The Pricing of Options and Corporate Liabilities" by Fischer Black and Myron Scholes. Without Black-Scholes, it's hard to imagine there would be derivatives with literally hundreds of trillions of dollars of notional value outstanding today.

Or consider just one more example: the publication in 1965 of "The Behavior of Stock Market Prices" by Eugene Fama. That publication and others like it brought us such developments as the index fund, the shelf registration system, the fraud-on-the-market theory — and much more.

Given the practical applications of theoretical finance, it's not surprising that today hedge fund managers regularly turn up at academic conferences and eagerly scour the academic literature for the next big thing.

Regulators should too. If the investment choice most important for retail investors these days is not which stock or bond to buy, but which fund (or other intermediary) to choose, we need to find ways to apply the insights recent finance theory has given us in the service of retail investors.

Let me illustrate with just a few examples: the first from behavioral finance, and then from the mathematical theory of active management — but don't worry, I'm not going to go mathematical on you. Obviously, in this lecture I have time to do justice to none of these examples, but merely to suggest the potential waiting to be exploited.

MUTUAL FUND MANAGERS: LUCK OR SKILL?

The burgeoning discipline of behavioral finance is predicated on the empirical observation that we're prone to certain categories of mental errors. Judge Posner, in his lecture here last year, noted this and referred to one failing in particular: the tendency to see patterns where they don't exist.

Undoubtedly, there once was survival value in this tendency. It's better to have an overly sensitive pattern recognition system in your brain that occasionally gives false positives when considering whether there's a tiger hiding behind the bush ahead. A false positive might lead to an unnecessary adrenaline dump into the bloodstream, but one may not get more than one chance to miss the tiger if there's one actually there.

When evaluating a manager's past performance, however, this tendency to see patterns where none exist leads to the irrational expectation that streaks will persist. As Judge Posner pointed out, people are very poor at intuiting probabilities.

We don't really need sturdy academic studies to tell us this; we know it from our own experience. But sturdy academic studies there are. And they inform us that, just as many gamblers erroneously believe in "hot streaks" and "cold dice," many investors believe a mutual fund that shows past performance better than an appropriate benchmark index is much more likely to continue to outperform in the future.

Countless academic studies, however, have shown that very often such outperformance fails to persist. Determining whether there's a statistically sound basis for concluding that a fund's past outperformance resulted from skill and not just luck, however, requires not only sophisticated statistical techniques but also access to information — detailed and complete trade and position records — that are not required to be made public. So, in most situations, it's actually impossible even for an investor with sophisticated statistical tools to tell from the publicly available past performance data whether a fund manager's past results more likely reflect skill or just luck.

Nonetheless, investors understandably want past performance information — what else is there to consider that's as interesting? — so we at the SEC require funds to disclose their 1-, 3-, 5- and 10-year historical return data. We then also require funds to tell investors that past performance doesn't necessarily predict future results — which, of course, is the only reason past performance would be of any interest at all to a new investor.

How does this work in practice? Outperformance is an asset magnet: the dollars flow to the funds that show records of outperformance.

Given that we know that people routinely give undue credence to the predictive power of streaks, and given that we know that fund outperformance often fails to persist, shouldn't we be encouraging mutual fund managers to explore how statistical tools might be used in appropriate cases to give investors more reliable indications whether there's any sound reason to believe a fund manager is skillful and not just lucky?

If we did, in many cases a fund's past performance might not differ from that of a relevant benchmark sufficiently to demonstrate skill. In some cases, there would be solid evidence of skill. Shouldn't investors know that? If you invest in mutual funds, wouldn't you like to know that?

THE HEDGE FUND CONCEALED IN YOUR MUTUAL FUND

Before we wrap all this up and take stock of where we stand, I have one final set of examples from an area in which our current approach doesn't seem to be keeping up with advances in finance theory, and that's with respect to the performance of actively managed mutual funds.

Let's perform a thought experiment that I think you'll find illuminating. Let's imagine that you have a nice balance in your 401(k) account and have allocated a portion of your 401(k) portfolio to stock. Let's further imagine that you're been persuaded that the stock market is pretty efficient, so you have decided to put the majority of those funds in an index fund that tracks the S&P 500. Finally, let's imagine that you nonetheless also believe you may have identified a hedge fund manager who just might be able to outperform the index, so you'd like to put a modest fraction of your portfolio with that manager. Of course, in the real world, assuming you're a retail investor like me, you probably couldn't get into the hedge fund. But this is a thought experiment, so we can just wave our magic wand and — presto! — you're in. In short, in your portfolio you've got most of your money in an S&P 500 index fund and a lesser amount in a hedge fund that takes long positions in some S&P 500 stocks and short positions in others.

So, as a result of these two investments, what's your total net position when you consider both of them together?

Well, if the hedge fund is long in a given stock, that position is added to the indexed position. But if the hedge fund is short that stock, it's instead subtracted. So your total net position is just a portfolio that, relative to the S&P 500, is overweighted in the stocks the hedge fund is long in and underweighted in the stocks the hedge fund is short in.

Which means your total net position looks a lot like most actively managed large-cap mutual funds: overweighted in some stocks, and underweighted in others, relative to the S&P 500.

In fact, let's now imagine you didn't go to the bother of buying a separate index fund and a separate hedge fund. Let's assume instead that you just decided to buy a single, actively managed, large-cap mutual fund. If you knew the over- and underweightings of the S&P 500 stocks held by your new actively managed mutual fund, you could then simply mentally reverse the process I just described and deduce the portfolio of the virtual hedge fund concealed within your actively managed fund. At any one moment in time, all that is required to do that is subtraction. Conceptually, the mutual fund portfolio minus an S&P 500 portfolio of the same size equals the virtual hedge fund portfolio.

So, an actively managed, large-cap mutual fund can be viewed as just a combination of a virtual index fund and a virtual hedge fund.

You with me so far?

The presence of the virtual hedge fund is, of course, why you chose active management. If there were zero holdings in the virtual hedge fund — no overweightings or underweightings — then you would have only an index fund.

Unfortunately, in real life this decomposition of a mutual fund into the sum of a virtual index fund and a virtual hedge fund can be accomplished only by someone in possession of all the detailed and complete trade and position information for the fund — information that funds are now required to make public only in snapshot form once a quarter. Analysts with access only to publicly available data must struggle along with statistical techniques to try to estimate what really happened. That's very limiting and really doesn't work very well. Nonetheless, as you may know, academics have attempted such analyses. And, if they chose to do so, funds could disclose the results of analyses of this kind without disclosing their proprietary trade and position information.

It's quite useful to think of an actively managed fund this way.

HOW MUCH DOES YOUR VIRTUAL HEDGE FUND COST?

First, for example, this way of looking at things focuses a bright light on the fees and expenses attributable to the virtual hedge fund. The fees and expenses of the virtual index fund should be consistent with the very small fees and expenses one would expect to pay for a real index fund of the same size. The balance of the fees and expenses incurred by the over-all fund are then attributable to the virtual hedge fund. When this analysis is done, the magnitude of those fees and expenses relative to the size of the virtual hedge fund sometimes is truly eye-popping. Which makes you think maybe this sort of analysis should be done, so investors can see what the results are.

HOW WELL DID YOUR VIRTUAL HEDGE FUND MANAGER DO?

Second, this way of looking at things also focuses a bright light on the performance of the virtual hedge fund. Unfortunately, indications from the academic literature suggest this performance can be less than satisfactory in some cases. In one academic study, for example, the absolute magnitude of the mean return in excess of the benchmark — the "alpha" — deduced by the author from published data covering over 150 large-cap funds was roughly 9%. That would have been respectable, had the sign been positive. Unfortunately, it wasn't. An average of minus 9% is not so good.

Of course, once you dilute the signal by slopping in the performance of a considerably larger virtual index fund — the way performance in fact is reported — the performance of the virtual hedge fund is masked, and things don't look anywhere nearly so bad.

IS YOUR VIRTUAL HEDGE FUND MANAGER ACTIVE ENOUGH?

Third, this way of looking at things also focuses a bright light on the relative size of the virtual hedge fund and the virtual index fund. Indications from the academic literature suggest in many cases the virtual hedge fund is far smaller than the virtual index fund.

Which means, using the Wall Street jargon, investors in some of these funds may be paying for alpha, but getting beta. They are paying the costs of active management, but getting instead something that looks a lot like an over-priced index fund.

So don't we need to be asking how to provide investors who choose active management with the information they need, in a form they can use, to determine whether or not they're getting the desired bang for their buck — and at what level of statistical reliability?

CLOSING

Well: there you have it.

The on-going deretailization of the last few decades shows no signs of abating. The compelling advantages that mutual funds and other intermediaries offer by way of professional management, diversification and economies of scale will continue to attract ever-growing numbers of retail investors.

The costs of retail-protective regulatory regimes will continue to encourage the development of both institutions-only trading markets and institutions-only asset classes, but reducing the protections afforded retail investors in response to this trend is rightly unthinkable. So we may need to start thinking about whether we can develop new approaches that efficiently afford retail investors indirect exposure to these new markets and asset classes without undue risk.

Also, we increasingly will need to focus on the consequences of the concentration of the ownership of our public companies in ever-fewer institutional hands. This means looking carefully at the non-economic motivations some of those institutions may have and considering difficult questions about what to do in response.

In addition, as the choice that matters for retail investors increasingly is which mutual fund or other intermediary to buy, not which stock to buy, we will need to bring all the latest tools from behavioral finance and finance theory to bear in the service of those investors.

And all of this will take place in a world in which globalization and the onrush of developing technology will be a constant backdrop. Much is uncertain, but one thing is clear: the future of securities regulation is guaranteed to be both challenging and intensely interesting. I, for one, look forward to it.

Thank you for your patience and attention.

Endnotes

¹ For the sake of tidiness, I should explain what I mean by a "retail investor." For our purposes, precision is unnecessary. By "retail investor" I just mean those investors who lack the sophistication or net worth to gain access to institutional markets; in other words, most individual investors. With this definition, however, some high net worth families and individuals don't qualify as retail investors.

² For the sake of completeness, I note that securities issued in 144A offerings often are later registered with the SEC in a somewhat technical process called an "Exxon Capital exchange," not to attract capital and liquidity from retail investors, but rather to help satisfy regulatory requirements that apply to some classes of investors, such as insurance companies. In the wake of the Sarbanes-Oxley Act, however, these offerings are increasingly structured as "144A for life deals," without any follow-on registration.