RESPONSE

Opacity, Complexity, and Self-Regulation in Investment Banking

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ABSTRACT

We discuss the role of professional standards in investment banking in light of Professor Tuch's wide-ranging and thought-provoking analysis. Professor Tuch identifies an ethical role for regulation, and suggests that professional examinations should instill ethical standards into investment bankers. We have a good deal of sympathy for this position. Nevertheless, Professor Tuch's conclusions are contestable. Our analysis hinges upon a discussion of the origins of professional standards in investment banking. We suggest that many standards evolved as responses to complex commitment problems in situations where contract was ineffective. It follows immediately that professional standards naturally change as contracting technologies improve. Regulations that preserve standards that no longer serve an economic purpose therefore come at a cost, which must be justified using another normative criterion. We argue that more foundational work is required before clear moral criteria can be established. In particular, regulations that seek to constrain the choices that bankers and their clients make must justify their interference with the moral good of personal autonomy.

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INTRODUCTION

Professor Tuch has written a provocative and engaging study of self-regulation in the investment banking industry.[1] His analysis, which we outline below, concludes that the system as currently constituted does not work, and he develops substantive policy suggestions designed to fix it. In short, he would like to see a more explicit emphasis in regulation upon ethical standards and more high-profile actions against investment bankers and the firms for which they work.

The Financial Industry Regulatory Authority ("FINRA") regulates investment bankers are broker-dealers. FINRA's net revenues in 2013 were $900 million and it holds an investment portfolio valued at approximately $2 billion,[2] yet very little has been written about its operation or its effectiveness. Professor Tuch therefore addresses a serious scholarly lacuna. His data are thought-provoking, and he presents a careful analysis of their economic and legal implications. His work is an important first step towards a deeper understanding of investment banker self-regulation.

Notwithstanding our appreciation of Professor Tuch's work, we take issue with some elements of his analysis. In particular, we argue that any discussion of the shortcomings of current investment bank regulation must follow a clearer explanation of the purpose that such regulation is intended to serve. Professor Tuch identifies an ethical role for such regulation. He states that a reformed self-regulator should place an emphasis upon "instilling an ethical mindset into investment bankers,"[3] for example by designing professional examinations to test investment bankers "on their

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[1] Andrew F. Tuch, *The Self-Regulation of Investment Bankers*, 83 GEO. WASH. L. REV. 101 (2014).

[2] FIN. INDUS. REGULATORY AUTH., FINRA 2013 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 9, 10 (2014), *available at* https://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p534386.pdf; *see also* Tuch, *supra* note 1, at 150–51.

[3] Tuch, *supra* note 1, at 173.

understanding of ethical principles, not simply their technical competence."[4] Indeed, he argues, along with William O. Douglas, SEC chairman from 1937 to 1939, that self-regulation derives its potency from its ability to regulate conduct and activity "'lying beyond the periphery of the law in the realm of ethics and morality.'"[5]

It seems very natural to argue that an industry regulator should police ethical standards. But, of course, ethics are contestable. When O. Douglas stressed ethics in regulation, did he refer to a need to ensure that our actions respect other people's moral autonomy?[6] Did he mean to affirm liberal values relating to freedom of choice?[7] Did he view morality as learned behavior that helps us to manage the complexities of social life?[8] Or did he have something entirely different in mind? Reasonable people can disagree over these points, so a demand for more ethics in investment banking needs to be fleshed out considerably before it can guide policymakers.

We believe that a more fruitful line of reasoning starts from a positive examination of investment banking practice, and only later proceeds to ethical questions. We start our discussion in this Response by identifying the central technological problem in investment banking markets. We argue that custom in investment banking evolved as a practical response to this problem. It follows that changes to investment banking mores reflect technological evolution. If so, there is a danger that codifying acceptable business practices could prevent bankers from responding to technological advances and, hence, restrict economic discovery in financial markets.[9]

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[4] *Id.*

[5] *Id.* at 112 (quoting JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 185–86 (3d ed. 2003)).

[6] In other words, did he refer to the Kantian imperative to treat people as means, rather than ends? *See* IMMANUEL KANT, GROUNDING FOR THE METAPHYSICS OF MORALS 36 (James W. Ellington trans., Hackett Publ'g Co. 2d ed. 1981) (1785).

[7] Freedom of choice derives its worth in liberal philosophy from the moral value of self-determination: the right to plot our own path through life. *See infra* note 105.

[8] This perspective is most associated with Hayek. *See, e.g.*, 1 F. A. HAYEK, LAW, LEGISLATION AND LIBERTY 37 (1973) ("Although there was a time when men believed that even language and morals had been 'invented' by some genius of the past, everybody recognizes now that they are the outcome of a process of evolution whose results nobody foresaw or designed.").

[9] Hayek famously stressed the social value of free markets in which unplanned experimentation would result in the discovery of mechanisms for dealing with complex informational problems. *See* F. A. HAYEK, NEW STUDIES IN PHILOSOPHY, POLITICS, ECONOMICS AND THE HISTORY OF IDEAS 181–82 (1978); F. A. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519, 524–25 (1945).

This observation explains some of the regulatory choices that Professor Tuch criticizes.

We believe that our argument explains many features of investment banking markets and that it identifies potential limitations to regulatory intervention. But we do not wish to suggest, like Pangloss, that all is for the best in the "best of all possible worlds."[10] Our Response includes some early suggestions for change.

Our comment starts with a short summary of Professor Tuch's argument. We then present a brief alternative analysis of self-regulation in investment banking, which we ground in the economics of information in highly complex and opaque markets. Our own work on this field is at an early stage, and our arguments are correspondingly tentative. We discuss some preliminary policy statements, and we conclude with a brief outline of some ethical problems in regulation.

I. TUCH ON SELF-REGULATION

Professor Tuch argues that effective regulation should deter investment banker misconduct, which he identifies as failures to serve client interests, to protect client confidences, to exercise skill and diligence, and to communicate accurately and completely with clients;[11] all of which he notes are "matters that are typically within the ambit of rules of professional responsibility or ethics."[12] Investment bankers are classified for regulatory purposes as broker-dealers and, hence, fall into the ambit of the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory organization.[13] Professor Tuch argues that self-regulation by FINRA is ineffective: "FINRA regulation underdeters investment bankers' misconduct. It would also seem to provide no credible deterrence against such misconduct."[14]

This conclusion is data-driven. Professor Tuch starts by identifying investment bankers as advisors to senior executives on major transactions, such as securities offerings and M&A deals.[15] He explicitly excludes from his definition bankers engaged in principal deals,[16] although he

[10] VOLTAIRE, CANDIDE 20 (John Butt trans., Penguin Books 1960) (1759).

[11] Tuch, *supra* note 1, at 105, 123–34.

[12] *Id.* at 105.

[13] *Id.* at 104.

[14] *Id.* at 109.

[15] *Id.* at 113.

[16] "Investment bankers do not typically sell securities, even though underwriting requires the sale of securities to investors." *Id.* at 115.

acknowledges that the line between traders and traditional investment bankers has been blurred in recent years by the emergence of financial conglomerates.[17] Investment bankers are classified as brokers because they effect transactions in securities for the benefit of others; they are therefore required to register individually with FINRA, which writes and enforces rules for its members.[18]

FINRA's Rule 2010 requires its members to "observe high standards of commercial honor and just and equitable principles of trade."[19] Hence, Professor Tuch argues, FINRA ought to regulate the professional standards with which he believes investment bank regulation should be concerned.[20] If FINRA regulation were effective then he ought to be able to identify every instance of unprofessional conduct in records of FINRA disciplinary actions. Accordingly, he uses monthly FINRA reports to identify every action between January 1, 2008 and June 30, 2013.[21] In the whole of this period FINRA sanctioned 4,116 individuals, of whom 18 were investment bankers, and sanctioned 1,645 firms, of which 16 were sanctioned for the conduct of their investment bankers.[22]

Investment bankers experience a relatively light volume of sanctions, particularly given the high volume of transactions they perform.[23] One interpretation of this fact is that investment bankers invariably exhibit the commercial honor and just and equitable behavior required of them by FINRA.[24] Professor Tuch rejects this interpretation on a number of grounds. First, he cites economic studies that strongly suggest banker misconduct in credit derivative trading and M&A deals.[25] Second, he

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17 *See id.* at 116 n.73 (noting that individuals at some financial conglomerates, such as Goldman Sachs, fulfill trading and investment banking functions).

18 *Id.* at 116–17.

19 FINRA MANUAL R. 2010 (2008); *see also* Tuch, *supra* note 1, at 121.

20 *See* Tuch, *supra* note 1, at 121–23.

21 *Id.* at 137–42. Professor Tuch also used public financial media sources "to identify any additional reported FINRA disciplinary matters." *Id.* at 139.

22 *Id.* at 141–42.

23 Based on Thomson Reuters data, Professor Tuch asserts that investment banker fees for M&A and security issuance in 2012 totaled approximately $35 billion. *Id.* at 124.

24 *See supra* text accompanying note 19.

25 Tuch, *supra* note 1, at 130 n.165 (citing Viral V. Acharya & Timothy C. Johnson, *Insider Trading in Credit Derivatives*, 84 J. FIN. ECON. 110, 134 (2007)); *id.* at 130 n.166 (citing Andriy Bodnaruk, Massimo Massa & Andrei Simonov, *Investment Banks as Insiders and the Market for Corporate Control*, 22 REV. FIN. STUD. 4989, 4990 (2009)); *id.* at 131 n.169 (citing Narasimhan Jegadeesh & Yue Tang, Institutional Trades Around Takeover Announcements: Skills vs. Inside Information 1 (Dec. 1, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1568859).

argues that current forms of self-regulation are prima facie highly unlikely to achieve the economically most efficient outcome, because they fail to meet the requirements for an economically optimal deterrent: in particular, regulations do not capture the full universe of potential misconduct,[26] do not impose sufficient sanctions to render the expected cost of abuse higher than its expected benefits,[27] and, finally, stop well short of the point at which the marginal benefit of further enforcement would exceed its benefits.[28]

Professor Tuch ascribes FINRA's apparent underperformance to a number of factors. He argues that FINRA is institutionally ill-equipped to deal with certain forms of misconduct, because it focuses upon investor protection[29] and gives weak incentives to clients to complain to FINRA.[30] He argues that a lack of clear rules and of institutional expertise hampers regulation,[31] and, finally, he suggests that the aristocratic status of investment bankers renders them "untouchable" by their social inferiors in the regulatory agencies.[32]

Weak self-regulation would not be a problem if other disciplining devices worked. But Professor Tuch argues that they do not; he points to poor reputational incentives, unsophisticated and weak principals, and legal barriers to enforcement.[33]

The analysis outlined in this Part appears to identify serious shortcomings in the self-regulation of investment bankers. Nevertheless, Professor Tuch does not reject self-regulation per se. He argues that self-regulation can more effectively regulate ethics than government regulation, and notes that self-regulation can best meet the needs of a specific industry.[34] But he calls for reform of self-regulation. He makes several suggestions. First, he argues for more precisely articulated standards of conduct.[35] Second, he suggests that the self-regulator should be prepared to rely upon the opprobrium of outside experts, such as judges in the

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26 Tuch, *supra* note 1, at 145.
27 *Id.* at 148.
28 *Id.* at 148–49.
29 *Id.* at 159–61.
30 *Id.* at 151–53.
31 *Id.* at 153–55.
32 *Id.* at 155–58.
33 *Id.* at 161–68.
34 *Id.* at 112–13.
35 *Id.* at 170.

Delaware Court of Chancery.[36] Third, he argues that the regulator should strategically target high-profile investment bankers so as to establish clear standards and to signal that no one is "untouchable" by regulation.[37] Finally, he argues that self-regulators should perform more extensive investigative work.[38]

II. THE CENTRAL CHALLENGE OF INVESTMENT BANKING

We believe that all of the difficult problems in investment banking spring from the same source. Investment banks exist to facilitate trade in situations of extreme unknowability.[39] For example, securities issuance is possible only when parties with specialized information about the issuing firm can cooperate with those who have detailed knowledge of market conditions.[40] Such information is hard to create and almost impossible to communicate credibly.[41] Similarly, mergers require the exchange of complex and hard-to-verify data.[42] The challenge for the parties to such transactions is to find a way to commit not to rip one another off when they share such information.

This observation opens two lines of inquiry. The first is economic: what is the best way for rational parties to pursue their self-interest in the presence of such severe informational frictions? The second is ethical: what is the right way for the parties to such a transaction to behave towards one another? It has already been suggested that the second question is too complex and too contested to be answered in general terms.[43] The discussion therefore must start by considering the first question.

The informational problems that surround investment banking are not new. In previous work, we traced the origins of investment bankers back to early nineteenth century transatlantic trade in cotton and dry commodities.[44] Rothschilds, Barings, Brown Brothers, and Peabody all started as trans-Atlantic commodity traders.[45] They faced severe problems.

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36 *Id.* at 171–72.

37 *Id.*

38 *Id.* at 172–73.

39 *See infra* note 55.

40 *See infra* note 55.

41 *See infra* note 61 and accompanying text.

42 *See, e.g.*, ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 255 (2007).

43 *See supra* text accompanying notes 6–9.

44 MORRISON & WILHELM, *supra* note 42, at 107–16, 123–26.

45 *See id.* at 113–16, 149–50.

Information travelled across the Atlantic at the speed a sailing boat could transport it, and nineteenth century legal institutions and international trading law were underdeveloped.[46] It was therefore very hard for the parties to a deal to make credible commitments to one another. If an English merchant could not observe the quality of cotton and had no recourse to the courts, how could he trust the seller? And, without trust, the seller could not sell his goods, and a valuable economic opportunity would be lost. In this environment, a party that could facilitate credible commitment without recourse to formal legal agreements had a critical advantage. The early Atlantic traders built reputations for fair-dealing and truth-telling that enabled them to extract valuable information about trading partners and to sustain extralegal commitments with them.[47] Those reputations were critical to trade, and so represented a barrier to entry and a source of profit. Traders maintained their reputations in order to sustain their long-term profitability.

The Atlantic traders were driven into investment banking by technological changes that enabled new entrants to compete with them. The introduction of expectation damages in commercial law,[48] the increasing sophistication of maritime trade law,[49] the inauguration of timetabled steamship crossings of the Atlantic,[50] and the opening of the transatlantic telegraphic cable[51] served to improve information flow in the commodities business, and to render commitment easier. As a result, reputational capital was no longer needed to underpin commodity transactions. The Atlantic traders reacted by moving into finance, where information was hard to measure and legal solutions remained elusive.[52] In the financial world, a reputation for honesty, fair play, and reliability therefore remained a critical source of advantage.

Information exchange and commitment remains difficult in the advisory investment banking work upon which Professor Tuch focuses.[53] Consider, for example, an initial public offering.[54] On one side of the

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[46] *See* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 404–07 (3d ed. 2005); MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1780–1860, at 141–47 (1977).

[47] MORRISON & WILHELM, *supra* note 42, at 107–09.

[48] FRIEDMAN, *supra* note 46, at 203–06.

[49] MORRISON & WILHELM, *supra* note 42, at 130.

[50] *Id.* at 100–01.

[51] *Id.* at 159.

[52] *Id.* at 121–54.

[53] *See* Tuch, *supra* note 1, at 113–15.

[54] For detailed discussions of the practice of, and academic evidence concerning,

transaction sits a corporation that has a better understanding of its product than anyone else.[55] On the other sit various investors who, while relatively ignorant of the precise qualities of the issuing firm, have a far better understanding of market conditions and the determinants of stock value than the firm.[56] Trade is possible only if investors have the right information to price the stock, and if the corporation's owners believe that investors will quote a fair price.[57] These requirements could easily be met if it were possible for investors to sign a contract contingent upon information revealed by the issuer and if each party had recourse to the courts in the event that the other were found to have revealed false information. But, even in today's technologically and legally sophisticated marketplace, this is largely impossible. It is difficult to prove that the corporation willfully suppressed information or that investors deliberately understated the value of the new issue.

The initial public offerings market therefore requires an institution that can sit between the parties to the deal and ensure that they reveal information and are punished for dishonesty. The investment bank fills that role.[58] It generates information about corporations and certifies its veracity; it also ensures that investors reveal price-relevant information. It punishes malpractice through exclusion from profitable future deals.[59] And, because its services are valuable, it earns a fee; the fear of losing future fees should serve to keep the investment bank honest.[60]

Investment bankers can be viewed as the maintainers of information marketplaces—they sit between the various parties to a transaction and facilitate the exchange of information on fair terms. It is very hard to perform such an exchange contractually: information cannot be described

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initial public offerings, see TIM JENKINSON & ALEXANDER LJUNGQVIST, GOING PUBLIC: THE THEORY AND EVIDENCE ON HOW COMPANIES RAISE EQUITY FINANCE (2d ed. 2001); Alexander Ljungqvist, *IPO Underpricing*, *in* 1 HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 375 (B. Espen Eckbo ed., 2007); *see also* MORRISON & WILHELM, *supra* note 42, at 76–80 (discussing the informational problems in initial public offerings).

55 Lawrence M. Benveniste & Paul A. Spindt, *How Investment Bankers Determine the Offer Price and Allocation of New Issues*, 24 J. FIN. ECON. 343, 344 (1989).

56 *Id.*

57 *Id.*

58 *Id.* at 345.

59 *Id.*

60 These ideas were first formally presented in game-theoretic models of investment bank relationships in the economics literature. *See id.* at 343; Lawrence M. Benveniste & William J. Wilhelm, *A Comparative Analysis of IPO Proceeds Under Alternative Regulatory Environments*, 28 J. FIN. ECON. 173 (1990).

in a contract without revealing it; verification of information exchange is impossible; and one cannot prevent an informed agent from selling his information more than once. But, even though it cannot use its knowledge in court, the investment banker can verify the quality and exchange of information, and it can use the threat of exclusion from the marketplace to ensure compliance with the rules.[61]

As the central parties in a complex extralegal marketplace, investment banks cannot fulfill their role unless they deal with both sides to a transaction. Conflict management is therefore part and parcel of the traditional investment bank's business, and investment bankers are inevitably conflicted. The effectiveness of the information marketplace depends upon the ways in which conflicts are resolved. A bank is more likely to attract clients to its information marketplace, and to earn high fees, when it is perceived never to abuse confidences, to ensure that information is used only by the parties to whom it is promised in the information marketplace, and to act in the interests of its clients even when they do not understand what those interests are. The traditional investment banker is therefore guided by enlightened self-interest to exhibit these qualities.

The standards to which investment bankers must adhere if they are successfully to run information marketplaces are constitutive of professionalism.[62] Our analysis suggests that professionalism evolved in investment banking as part of the response by self-interested agents to a complex economic and social problem. Part III uses the same analysis to explain recent changes to professional standards.

III. COMPUTERIZATION AND CONGLOMERATION

Professor Tuch suggests that professional standards have slipped in investment banking. If, as we argue above, professional standards are an optimal response to the economic environment, then changed standards should reflect a changed environment. The most significant change to investment banking in recent years is the increased importance of financial conglomerate firms, which provide advisory investment banking services

[61] For a classic discussion of the problems of informational trade, see Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention*, *in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY: ECONOMIC AND SOCIAL FACTORS 609 (Nat'l Bureau of Econ. Research ed. 1962).

[62] Of course, professionalism is a complex subject. We do not attempt in this brief Response to engage with the literature on the topic. For perspectives related to ours, see Thomas L. Shaffer, *Inaugural Howard Lichtenstein Lecture in Legal Ethics: Lawyer Professionalism as a Moral Argument*, 26 GONZ. L. REV. 393 (1990); W. Bradley Wendel, *Professionalism as Interpretation*, 99 NW. U. L. REV. 1167 (2005).

alongside principal dealing businesses. Professor Tuch stresses the wide scope for professional misconduct in such conglomerates.[63] But, clients who worry about conflicts of interest in full-service banks need not trade with them: advisory-only "boutique" investment banking firms started to emerge in the early 1990s, and are now a well-established alternative to the full-service investment banks.[64] Some natural questions therefore arise. Why did conglomeration occur, and what caused the formation of boutique investment banks? And, if conflicts are bad for business, why do conglomerate firms continue to attract clients?

Conglomeration is one of many responses to technological shocks as seismic as those that caused the nineteenth century Atlantic traders to specialize in financial services.[65] The late twentieth century shock came from information technology. Computers started to transform Wall Street in the 1960s, when they were mostly used for settling trades.[66] They started to have a significant impact in traditional investment banking in the 1980s, when microcomputers were introduced in bank front offices.[67] We have documented elsewhere the enormous impact of spreadsheet applications upon the M&A business, for example.[68] Similarly, underwriting practice shifted as it became possible to perform rapid valuation and to maintain electronic client records.[69]

Computing was not merely a cost-cutting technology. It changed the way that bankers did business, most notably by moving financial economics out of the classroom and into the banks. Theoretical advances in option pricing due to Fischer Black, Robert Merton, and Myron Scholes were adopted as practical trading recipes as soon as there was sufficient distributed computing power to implement them.[70] As a result, many activities that formerly had rested upon investment banker judgment were

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63 Tuch, *supra* note 1, at 124–25.

64 *See, e.g.*, MORRISON & WILHELM, *supra* note 42, at 302–05.

65 *See supra* notes 45–52 and accompanying text.

66 *See* MORRISON & WILHELM, *supra* note 42, at 228–31.

67 *See, e.g.*, Alan D. Morrison & William J. Wilhelm, Jr., *The Demise of Investment Banking Partnerships: Theory and Evidence*, 63 J. FIN. 311, 340 (2008).

68 MORRISON & WILHELM, *supra* note 42, at 239–40.

69 *Id.* at 241–42.

70 The seminal papers on asset pricing are Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973), and Robert C. Merton, *Theory of Rational Option Pricing*, 4 BELL J. ECON. & MGMT. SCI. 141 (1973). For a discussion of the adoption of these ideas into investment banking practice, see Morrison & Wilhelm, *supra* note 67, at 340–44.

now susceptible to formal contracting.[71] In a business that for over a century had existed to manage transactions in situations not susceptible for contract, this was a significant change. Like the nineteenth century Atlantic traders, investment bankers found themselves subject to competition from new entrants, and in some businesses were forced for the first time to compete on the basis of verifiable information.[72]

The impact of this change cannot be overstated. As traditional investment banking was codified, it started to move into dealing rooms. The blurring of investment banking and principal trading to which Professor Tuch refers[73] was then inevitable. Modern investment bankers give advice over information that is relatively easier to verify than ever before. As a result, they frequently see themselves as engaging in an arm's-length transactional business rather than one based upon close relationships and traditional professionalism, as we defined it above.[74]

A striking illustration of this shift is due to Lloyd Blankfein, chairman and chief executive of Goldman Sachs. In his testimony to the U.S. Congress in the wake of the SEC's action over the ABACUS securitization deal, Mr. Blankfein stated of Goldman Sachs's role in securitization deals: "[C]lients are buying . . . an exposure. The thing that we are selling to them is supposed to give them the risk they want. They are not coming to us to represent what our views are. . . . They shouldn't care."[75]

Mr. Blankfein appears explicitly to rule out the possibility that Goldman Sachs should do anything more than provide the best possible price to their customers. The other professional services identified as critical by Professor Tuch[76] are explicitly ruled out: Goldman denies an obligation to advise clients or to look out for their best interests.

We do not believe that Goldman Sachs' clients are unsophisticated.

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71 *See* Alan D. Morrison & William J. Wilhelm, Jr., Trust, Reputation and Law: The Evolution of Commitment in Investment Banking 5–6 (Aug. 2014) (unpublished manuscript) (on file with the authors).

72 *See supra* notes 44–52 and accompanying text.

73 *See supra* notes 58–62 and accompanying text.

74 *See supra* note 62 and accompanying text.

75 *See Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Gov't Affairs*, 111th Cong. 134 (2010) (statement of Lloyd C. Blankfein, Chairman & Chief Executive Officer, The Goldman Sachs Group, Inc.). For a detailed analysis of the ABACUS transaction and its implications, see Steven M. Davidoff, Alan D. Morrison & William J. Wilhelm, Jr., *The* SEC v. Goldman Sachs*: Reputation, Trust, and Fiduciary Duties in Investment Banking*, 37 J. CORP. L. 529 (2012).

76 *See supra* text accompanying note 11.

That they understand the nature of their relationship with the bank is borne out by the fact that the bank survived these remarks and the congressional hearing in which they were made with no more harm than that occasioned by their $550 million settlement with the SEC.[77] Why, then, do clients continue to give Goldman Sachs their business?

The answer to this conundrum lies in the changing nature of commitment in investment banking deals. Close relationships are required to sustain tacit agreements when information is complex and hard, or impossible, to verify. When new technologies render information easier to measure, it becomes easier to contract and, as a result, relationships can become more distant. In businesses where this happens, bankers no longer need to exhibit the norms that render extralegal commitment possible. Clients would like to deal with the most technically adept banker, even if his or her skills are not coupled with the virtues of the classical professional.[78]

In this type of environment results are easier to verify than ever before and, hence, so is skill. Moreover, as relationships become more contractual, a skillful new entrant has a chance of unseating an incumbent whose historic competitive advantage derived from its ability to sustain noncontractual commitment. The consequence in investment banking was an intensification of competition. Margins shrank and, as a result, scale became important.[79] Bankers who can manage complex contractual relationships across multiple product ranges prosper in the new contractual environment, and we believe this explains the emergence of the financial conglomerate.[80]

Of course, while conglomerates are well-placed to profit from economies of scale and scope, they are also subject to conflicts. In recent work with Zhaohui Chen we argue that such conflicts derive from new codification technologies.[81] When it is easy for clients to measure

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77 *See* Davidoff, Morrison & Wilhelm, *supra* note 75, at 529.

78 This observation generates new conflict of interest problems in financial conglomerates. *See infra* text accompanying note 81.

79 For a discussion of these effects, see Morrison & Wilhelm, *supra* note 67, at 341–44.

80 *See* Alan D. Morrison, *Universal Banking*, *in* THE OXFORD HANDBOOK OF BANKING 171, 187–88 (Allen N. Berger, Philip Molyneux & John O.S. Wilson eds., 2010).

81 Zhaohui Chen, Alan D. Morrison & William J. Wilhelm, Jr., *Investment Bank Reputation and "Star" Cultures*, 2 REV. CORP. FIN. STUD. 129 (2014) [hereinafter Chen, Morrison & Wilhelm, *Investment Bank Reputation*]; Zhaohui Chen, Alan D. Morrison & William J. Wilhelm, Jr., *Traders vs. Relationship Managers: Reputational Conflicts in Full-Service Investment Banks*, 28 REV. FIN. STUD. (forthcoming 2015) [hereinafter Chen,

performance, bankers can establish personal reputations for competence.[82] They may therefore take short-term actions so as to signal their expertise, and so increase their value in a competitive labor market; for example, they may structure an unnecessarily complex securitization or a complex cross-border takeover.[83] Such actions need not be in the best interests of their clients.[84] As a result, bankers face a conflict between their short-term desire to establish their competence and their long-term reputation for client care.[85]

This type of conflict is inevitable in a complex, full-service financial conglomerate.[86] When clients deal with such a conglomerate they accept it as a price of dealing with such a firm. They could elect to avoid conflicts by dealing with a boutique firm that specializes in the noncodifiable and tacit businesses where these effects do not arise.[87] The continued existence of both types of firm indicates that there is scope for both approaches to business.

Our analysis helps us to think about some of the questions raised in Professor Tuch's article. First, if we wished only to maximize economic production, how could we best regulate traditional advisory investment banking? Second, how should such regulation address the emergence of more contractual modes of investment banking, and the concomitant emergence of financial conglomerates? Finally, to what extent should our approach to regulation be tempered by ethical considerations?

These are substantial and difficult questions. The following three Parts are a first attempt to answer them.

IV. ENABLING INFORMATION MARKETPLACES

We argue above that the traditional investment banker can be usefully conceptualized as maintaining an information marketplace, within which the parties to complex transactions can safely exchange price-relevant

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Morrison & Wilhelm, *Traders vs. Relationship Managers*], *available at* http://rfs.oxfordjournals.org (subscription required).

82 Chen, Morrison & Wilhelm, *Investment Bank Reputation*, *supra* note 81, at 129–30; Chen, Morrison & Wilhelm, *Traders vs. Relationship Managers*, *supra* note 81, at 2–3.

83 Chen, Morrison & Wilhelm, *Traders vs. Relationship Managers*, *supra* note 81, at 2–4.

84 *Id.*

85 *Id.* at 2–4.

86 *Id.* at 26 ("[T]he presence of a genuinely impermeable Chinese Wall between business units . . . [i]n practice . . . is difficult to achieve.").

87 *Id.* at 5–6, 8–9, 32–33; Chen, Morrison & Wilhelm, *Investment Bank Reputation*, *supra* note 81, at 148–49.

information.[88] Traditional investment banks are therefore structured to render the promises made within the information marketplace credible. Those promises are most credible when they are made by investment bankers who exhibit professionalism.[89] Hence, when information marketplaces are difficult to establish, it is in everyone's interest that an investment banker commit to maintain high professional standards. Such standards attract clients to the information marketplace, and so ensure both that the investment banker earns fees, and that capital flows to deserving causes. So investment bankers should welcome any device that enables them to commit to the requisite standards.

A natural device would be a formal enumeration of the investment banker's jobs, backed by the legal authority of a regulatory agency. But such a device could not work, for the same reasons that a formal contractual informational marketplace is impossible: the investment banker is employed to manage the flow of privileged information that is hard-to-codify and very difficult to prove in court. The best we can do with hard data is to exhibit patterns of misconduct, as in the economic studies cited by Professor Tuch.[90] But it would not be possible to bring a successful prosecution using those data. Those studies use data from many deals to show that broad patterns of misconduct occurred with high probability. Individual deal data has no statistical significance in this type of analysis and, hence, the hard data used in these studies could not be used as the basis of an enforcement action in court.

In short, data about specific deals is insufficiently precise to serve as the basis for formal regulation of investment banks. It follows that any form of regulation in the traditional investment banker businesses must be based to a large extent upon information that cannot be enumerated, and upon an expertise of banker activities that is largely tacit and that cannot be reduced to a rule book. We believe that it is for this reason that self-regulation emerged as the preferred approach in investment banking. That is, as William O. Douglas noted, self-regulation is uniquely well-placed to "regulate conduct and activity 'too minute for satisfactory control.'"[91] But this regulation can be viewed as emerging to facilitate trade in information, rather than, as O. Douglas continues, to deal with the "'realm of ethics and morality.'"[92]

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88 *See supra* text accompanying note 61.

89 *See supra* note 62 and accompanying text.

90 *See supra* text accompanying note 25.

91 Tuch, *supra* note 1, at 112 (quoting SELIGMAN, *supra* note 5, at 185–86).

92 *Id.* (quoting SELIGMAN, *supra* note 5, at 185–86).

Viewed from this purely instrumental perspective, what would the ideal regulator of traditional investment banking look like? Our analysis suggests several features.

First, the regulator should have sufficient expertise to understand the tacit skills that the investment banker deploys in running its information marketplace. This requirement is in line with Professor Tuch's analysis, which points towards a lack of institutional expertise in FINRA.[93]

The second requirement flows from the first. Given that a bank's decisions can be understood only by its peers, the regulations to which it is subject cannot be very detailed. There is a role for the codes of practice that Professor Tuch advocates,[94] but these cannot go beyond procedural requirements and broad statements of intent. A banker can agree to respond appropriately to conflicts, but only another banker can decide whether the response in a particular instance was indeed appropriate.

We therefore arrive at a third requirement. Effective regulation works only if it enhances the information marketplace; it should not be used to undermine competition between investment banks. Self-regulation is necessary because the relevant terms of art can only be interpreted in specific situations by experts. But, for precisely this reason, a system of self-regulation is open to abuse. A court cannot determine the veracity of a regulator's pronouncements and, hence, bankers cannot face court sanctions for falsely claiming to identify malpractice at their competitors. By the same token, bankers who enter into a collusive agreement never to reveal one another's malpractice cannot be detected. The self-regulator must therefore be designed to prevent both forms of abuse. A truly independent regulator is probably impossible because, as Professor Tuch argues of FINRA,[95] it would most likely lack the expertise needed to regulate effectively. A better approach would be to design an effective system of whistleblowing and appeal into the self-regulator's make-up. The design of such a system lies beyond the scope of this Response.

The fourth requirement is that the regulator be able to publicize malfeasance. Information marketplaces function because their participants trust the bank that sits at their center.[96] A loss of trust is therefore very costly for the bank, and the threat of that loss serves to keep the bank

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93 *Id.* at 153–55.

94 *Id.* at 170–71.

95 *Id.* at 153–55.

96 Davidoff, Morrison & Wilhelm, *supra* note 75, at 541.

honest. In other words, and contrary to Professor Tuch's analysis,[97] self-regulators can provide strong incentives for compliance even if they do not impose severe financial penalties for wrongdoing.

Fifth, the regulator should reveal information that participants in the information marketplace could not easily establish for themselves. The parties most likely to suffer from information asymmetry are corporations. Most have only infrequent contact with the financial markets, and so are both unlikely to identify misconduct and also unable to punish wrongdoing through a withdrawal of business. Hence, as Professor Tuch suggests,[98] FINRA's emphasis upon investor protection is likely to be misplaced.

Note, though, that we do not suggest that corporate clients are unsophisticated. The principal-agent problems to which Professor Tuch refers[99] are characterized by an asymmetry of information, but not necessarily by unsophisticated principals. A sophisticated principal designs its interaction with the agent so as to minimize the expected costs caused by the agent's unobservable self-interested behavior. Stock option compensation can be viewed as a sophisticated response to a principal agent problem; so, too, can a well-designed system of self-regulation. Corporate clients cannot observe the actions of their bank, but they can anticipate its response to the incentives embedded in regulation. They are therefore more likely to join an information marketplace governed by good regulations.

Of course, corporations that enter the financial markets only infrequently cannot manage a self-regulatory system. But they can vote with their feet. We therefore derive a sixth implication. Self-regulation should leave sufficient freedom of action for banks to compete on the basis of the regulatory regime to which they expose themselves. This competition should not amount to a free-for-all. But it should leave bankers free to adopt slightly different codes of practice, and to be held to differing promises to investors.

V. REGULATING CONFLICTS IN CONGLOMERATES

Part IV characterizes the optimal regulation of traditional investment banking businesses, in which information is nonverifiable and very hard to interpret. But, as we note in Part III, in some businesses it is extremely hard to disentangle the old-fashioned tacit approach to investment banking

97 Tuch, *supra* note 1, at 147–48.
98 *Id.* at 159–61.
99 *Id.* at 162–66.

from new, more contractual, ways of doing business. In this Part we briefly discuss the regulation of investment banking business within large and conflicted conglomerate business. We continue to consider regulation as an instrumental device intended to facilitate efficient trade, and we defer ethical questions until the next Part.

Regulation in financial conglomerates is challenging because choices that work in traditional investment banking are less effective in modern contractual businesses. We argue above that clients are less concerned for professional standards when they believe that they can rely upon black letter law to ensure that commitments are honored.[100] Hence, a regulatory regime built upon the power of credible admonishment to harm delinquent firms' businesses cannot succeed in such businesses. But, because behavior and outcomes can be more precisely measured in such businesses, they are susceptible to the type of formal regulatory approach that we argue cannot work in traditional investment banking.

We therefore arrive at the uncomfortable conclusion that a conglomerate financial business would ideally face two sorts of regulation. Its traditional advisory work would be subject to self-regulation of the type we outline in Part IV, while its more contractual, principal-based business would face formal regulation. This conclusion generates as many problems as it solves. We confine ourselves in this Response to an outline of three challenges; our recent work addresses some of them in greater depth.[101]

First, it is extremely difficult to establish a precise border between traditional businesses that should be self-regulated, and modern contractual ones that should not. Many banking activities contain elements of both, and, as per the preceding paragraph, placing an activity on the wrong side of the line will result in ineffective and efficiency-reducing regulation. The only way to be sure that this does not happen may be to combine both forms of regulation in a single body. That body would require both the formal authority needed to enact precise rules, and the freedom to perform judgment-based self-regulation. The possibilities for regulatory capture and the consequential need for appropriate oversight would therefore be magnified significantly.

Second, the standards that the regulator should impose in pursuit of economic efficiency are different in traditional and modern investment banking. We argue above that norms of professionalism are important in the former, because they enable the banker credibly to commit itself in the

[100] *See supra* text accompanying note 78.

[101] *See* Morrison & Wilhelm, *supra* note 71.

management of its information marketplace. But those norms are less important in arm's-length transactional businesses, where clients can protect themselves contractually. The regulator in those businesses is therefore more properly concerned with adequate disclosure, accurate reporting, and anything else that facilitates precise contracting.

Third, the type of sanction required in the traditional information marketplace is very different than the one needed in the modern contractual business. All a self-regulator need do in the former case is to publicize its decisions; sophisticated clients can then decide whether to abandon the delinquent banker, so that the optimal economic punishment arises endogenously. In the latter case, because new clients can protect themselves contractually, they need not abandon a bank after misconduct is revealed and, hence, higher monetary penalties are required. In other words, we believe that Professor Tuch's call for higher penalties is justified, but only in newer and more contractual financial businesses that should be formally regulated, and not in self-regulated businesses.

Our conclusions are somewhat tentative, but they are also troubling. We have argued that professionalism is an instrumental virtue, which emerged in investment banking as a means towards efficient economic exchange. If our only concern was efficient exchange then we should be prepared to abandon this virtue as it is displaced by more contractual ways of doing business. But many view professionalism as an ethical quality,[102] and they will argue that our instrumental conclusions should be tempered by ethical considerations. We do not wish to take a definitive position on this question, but we believe that our analysis at least helps us to frame the ethical choices that we face more precisely. The next Part is a first, and very brief, attempt to do so.

VI. REGULATION AND ETHICS

Professor Tuch places ethical standards at the heart of his criticism of investment banking. He argues that self-regulation should be informed by ethical considerations, and suggests that professional examinations should test ethical understanding.[103] We have argued that, in fact, the professional standards that he wishes to protect emerged as an optimal response to a complex informational problem.[104] The same standards are currently under pressure, because new information and legal technologies have changed the

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[102] *See, e.g.*, Shaffer, *supra* note 62, at 393–98, 405, 409.
[103] *See supra* text accompanying notes 3–5.
[104] *See supra* text accompanying notes 44–52.

informational environment.

Every ethical decision has an ethical content, and the choice we face here is not cut-and-dried. If our analysis is correct, then professional standards emerged through a market discovery process. It follows that a market discovery process would cause the same standards to recede in some businesses. The process of change is clearly costly. Economic actors who fail to understand the new business environment are likely to suffer if they rely upon traditional norms of professionalism. At the least, one could argue that the movement to more contractual investment banking relationships should be managed so as to minimize such harm.

A deeper question arises, though. Although Professor Tuch does not explain in his Article the basis of his preference for professionalism, he does not appear to believe that the regulator's role is to manage an orderly shift from professionalism to arm's-length contract. His preferences may derive from a belief that professionalism constitutes a collection of values that enrich our social lives and which, therefore, have a value quite apart from their impact upon economic relationships. In other words, he may have a deontological perspective on professionalism: that is, one in which the good incorporates the nature of our actions as well as the outcomes that they cause.

We cannot criticize this position. It is one for which we have a good deal of sympathy. But it is worth noting that it is not inevitable. One could equally argue that it is unethical to restrict economic output. Less crudely, a substantial liberal literature argues that ethical choices respect individual autonomy.[105] That literature leads naturally to one that respects freedom of contract as an expression of our autonomy.[106] If two parties wish to enter into an arm's-length contractual relationship that is not hampered by tacit understandings of professional standards, what right have we to prevent them from doing so? This line of argument suggests that the ethical response to Lloyd Blankfein's remarks about securitization at Goldman Sachs[107] is to accept them. If we accept this argument then we should require investment bankers to endorse freedom of contract in their professional examinations.

We do not propose to pursue these questions here.[108] But we make

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[105] *See, e.g.*, JOSEPH RAZ, THE MORALITY OF FREEDOM 108, 154–57 (1986); JOHN TOMASI, FREE MARKET FAIRNESS 40–41 (2012).

[106] *See, e.g.*, Randy E. Barnett, *The Function of Several Property and Freedom of Contract*, SOC. PHIL. & POL'Y, Jan. 1992, at 62, 76–78.

[107] *See supra* text accompanying note 75.

[108] For a more careful discussion of some of them, see generally Alan D. Morrison,

two salient observations. First, on a specific point, Professor Tuch argues in his piece that self-regulators should deliberately target enforcement actions against high-profile bankers, in order to counter a perception that investment bankers are "untouchable."[109] Of course, more prominent bankers should be as subject to regulation as less prominent ones. But we view this as one of Professor Tuch's less-convincing statements: neither in his discussion of enforcement[110] nor anywhere else do we see hard evidence that prominent investment bankers are indeed treated with kid gloves. And, more importantly, we find his policy suggestion hard to square with his emphasis elsewhere upon ethics. In short, he wishes to pursue prominent bankers pour encourager les autres.[111] We find it impossible to reconcile this policy prescription with a liberal perspective, and it seems to us unlikely to find a place in any mainstream deontological world view. We certainly find it very hard to square with the Rule of Law.

A second, more general, statement emerges from our analysis. Ethics are complex and disputed. Any policy framework built upon a general desire to instill more ethical behavior stands upon very uncertain foundations. At the very least, such a framework requires a much more detailed blueprint.

CONCLUSION

In discussing Professor Tuch's work, we have made a number of points. We have identified professionalism as the product of economic discovery, and we have asked what its ethical status is. This immediately raises foundational questions about the role of regulation. We have also identified an institutional trend towards financial conglomeration, which combines traditional relationship-based investment banking with newer arm's-length transactional businesses. We argue that the regulatory needs of these businesses are very different, and that the biggest challenge in this area is to design regulatory institutions that adequately meet these needs.

We have taken issue in this Response with some of Professor Tuch's proposals for investment bank regulation, and we have suggested that his

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Meta-Contracting, Regulation, and Corporate Governance: A Liberal Theory of the Firm (Jan. 2014) (unpublished manuscript) (on file with the author) (discussing the desirability of the free market as a moral good and suggesting that market regulation can be measured against its moral cost).

109 Tuch, *supra* note 1, at 155–58.

110 *Id.* at 153–61.

111 VOLTAIRE, *supra* note 10, at 111 ("[B]ut in this country we find it pays to shoot an admiral from time to time to encourage the others." (internal quotation marks omitted)).

discussion of ethical standards needs firmer foundations. But this is not to detract from his analysis. His work is ambitious, addresses an important topic, brings important data to bear, and identifies a number of important questions for research. It therefore deserves a wide audience, and we are very happy to have had this opportunity to engage with him.