Chapter 2

An Accident Waiting to Happen: Securities Regulation and Financial Deregulation

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The specific missteps that triggered the current financial debacle have been extensively criticized. The easy-money policy of the Greenspan Federal Reserve after 2000, misaligned exchange rates that sustained large global financial imbalances, a housing bubble inflated by Fannie, Freddie, and subprime lenders, forays by insurance companies such as AIG into activities outside the purview of insurance regulators, AAA ratings bestowed by rating agencies on securitized debt obligations, and the comprehensive recklessness of the large banking houses have received their due reproach.

This chapter looks at some longstanding underpinnings of the crisis: factors that helped turn the recent lapses of bankers, rating agencies, and mortgage brokers into a crisis of extraordinary proportions and scope. Finance, I will argue, has been on the wrong trajectory for more than half a century. Its defects derive from academic theories and regulatory structures whose origins date from the 1930s, which encouraged financiers to rely on blind diversification as a substitute for due diligence and ongoing relationships.

As with any "structural" explanation, my analysis cannot tell us why problems unfolded in a particular manner. Yet without such an analysis we cannot understand basic defects in the foundation of our financial system.

The Effect of Make-Believe Models on the Real World

Until the 1930s economists had two views of uncertainty. Frank Knight, who dominated the University of Chicago economics department through the late 1940s, and John Maynard Keynes highlighted uncertainties that could not be reduced to quantifiable probabilities. On the other side, followers of the Reverend Thomas Bayes developed theories in which all uncertainties were quantified, like the odds of hitting a number on a roulette wheel. The two views didn't necessarily conflict: economists used whichever best suited their problem and approach. But the Bayesian view became dominant[1]—not because it was established that people can, do, or should always think probabilistically, but because this notion allowed economists to build seemingly scientific mathematical models that more or less drove the old "literary" or "narrative" style of analysis to the fringes of economics.

Further mathematical convenience was purchased by assuming that because everyone is omniscient, all individuals form identical probability estimates. Even though this assumption had no "microfoundations" (Elster 2009)—we have no reason to think that everyone would form the same estimates—and even though it led to what philosopher Jon Elster (2007) calls "science fiction" economics, it came to underpin basic theories of modern finance. The Capital Asset Pricing Model (CAPM), for instance, assumes that all investors place exactly the same value on all stocks. This is self-evidently false: without buyers who believed that IBM's shares were cheap and sellers who thought them dear, there would be virtually no trading of IBM stock.[2] Yet CAPM has "become the backbone of modern price theory of financial markets" (Lindbeck 1990).

Worse, when the assumption of identical probability estimates conquered the theoretical journals, it provided a springboard from which make-believe modeling could extend its sway over financial practice, too.

In the real world of old, faced with unquantifiable uncertainty, sensible investors, bankers, and borrowers made subjective judgments in the holistic manner of a common-law judge, considering all the relevant precedents and features of the case at hand, and anticipating the possibility of mistake and ignorance. Or, as John Kay (2009) puts it, they tried to construct a coherent narrative to guide their decisions. Too, their concerns about unforeseeable developments encouraged the development of ongoing relationships that facilitated the judgments necessary for mid-course changes. If all uncertainty can be reduced to probability distributions, however—and if (assumed) omniscience ensures that market prices always accurately reflect the risks—then case-by-case judgments and ongoing relationships are unnecessary. Returns are maximized for the least risk and negligible cost simply through diversification.

In 1974 Paul Samuelson, who had spearheaded the theoretical triumph of mathematical economics, issued investors a "Challenge to Judgment" in the first issue of the *Journal of Portfolio Management*. The world of "practical operators," Samuelson wrote, was giving way to a "new world of the academics with their mathematical stochastic [probabilistic] processes." The academics understood that valuing individual securities was a wasted effort. Ordinary investors should understand this too, Samuelson counseled. Eschew stock picking—just buy a diversified market portfolio and throw away the key.[3]

Of course, it is imprudent for investors to put all their eggs in one basket; and conversely, as formalized in the CAPM, the sum of many independent gambles may not involve great risk. Similarly the Samuelsonesque hypothesis that market prices are "efficient" provides a useful starting point for investors: hasty judgments that market prices are too high or low are unwise. But, except in an imaginary universe of known probability distributions, relying on diversification to substitute for due diligence and ongoing oversight is delusional. Backing twenty thieves or buying a basket of 500 inflated bubble stocks does not produce higher returns than going with a single Madoff or WorldCom.

Moreover, blind diversification involves free riding, so it can't work if it becomes widespread. Dispensing with the costs of active investment management seems astute—even high minded. But, like littering or not voting, it's unsustainable en masse: if everyone eschews judgment, who will make market prices even approximately right, or exclude from the diversified portfolio the offerings of thieves and promoters of worthless securities? Sensible investors, who are predisposed to believe that well-functioning markets price assets accurately, must at least make an ongoing effort to assess whether the other players are doing what it takes to keep the markets well functioning.

Nonetheless, the Samuelson prescription proved enormously influential. Reading "Challenge" inspired John Bogle to launch the first stock index fund in 1976, and by November 2000 it had become the largest mutual fund ever, with $100 billion in assets. Case-by-case investing didn't completely disappear, of course. Venture capitalists who invest in young, unlisted companies continue to use the "common-law," due-diligence approach and maintain close ongoing relationships with the companies in their portfolios. But this active style was progressively banished to the margins. The standard formula for institutional investors comprised a core holding of the Standard and Poor "500" stock index, with peripheral investments in venture-capital funds and other such "alternative" vehicles.

Free riding through blind diversification took off in the credit markets as well. Bruce Bent launched the first American money-market fund in 1970. Now nearly 2,000 funds manage about $3.8 trillion. Like stock-index funds, money-market funds eliminated the costs of case-by-case judgment and of maintaining ongoing relationships: they simply bought a diversified portfolio of short-term instruments certified as high quality by a rating agency—a certification that cost the money-market fund nothing. The traditional relationship model of bank lending, encumbered by the overhead of loan officers and committees, faced significant cost disadvantages.

The emergence of ingenious schemes to take advantage of money-market funds that depend entirely on free double- or triple-A certification by Standard and Poor's and Moody's (which themselves have come to rely on stochastic modeling processes rather than on costly shoe-leather due diligence) was also unsurprising. Losses on debt issued by Lehman Brothers broke Bent's pioneering reserve money-market fund in September 2008. The debt was, of course, rated AA or AAA; that is the law governing money-market funds. But not all highly rated securities homogeneously deserve high ratings.

How Regulation Encouraged Mass Equities Trading

The regulatory apparatus whose origins date back to the 1930s was designed to protect bank depositors and investors in publicly traded securities. It has also unwittingly undermined due diligence and ongoing relationships, but, as we will see, in quite different ways: protection of securities markets has become too strong and regulation of banking too weak.

Federal securities regulation involves a subtle tradeoff. It sustains the unparalleled liquidity and breadth of U.S. stock markets, but it also fosters antagonistic, arms-length relationships between shareholders and managers (Bhidé 1993, 1994a). The foundations of this regulatory system can be traced to the extensive losses suffered by the public during the Crash of 1929. Between September 1, 1929, and July 1, 1932, stocks listed on the New York Stock Exchange lost 83 percent of their total value, and half of the $50 billion in new securities that had been offered in the 1920s proved to be worthless. The losses were widespread: according to the SEC, the Crash followed a decade in which some 20 million shareholders "took advantage of the postwar prosperity and set out to make their 'killing' on the stock market," giving "little thought to the inherent dangers in unbridled market operation." Responding to "the outraged feelings of voters," Congress passed the Securities Act of 1933, and in 1934 its Securities Exchange Act created the SEC (SEC 1984, 7).

Prior to the early 1930s, the response to stock-market panics had been to let the victims bear the consequences of their greed and to prosecute frauds and cheats. The new legislation had a revolutionary preemptive orientation: it sought to protect investors *before* they incurred losses, in three ways.

First, to help investors make informed trading decisions, the acts required issuers of securities to provide information about directors, officers, underwriters, and large shareholders, and about the organization and financial condition of the corporation. Issuers were also required to file annual and quarterly reports, following rules prescribed by the SEC. Over the years, SEC efforts substantially increased the length and quantity of the reports companies had to file. For example, companies had to disclose management perks and overseas payments and provide replacement-cost and line-of-business accounting. The laws backed the disclosure rules by providing criminal penalties for making false or misleading statements and by empowering the SEC to suspend the registration of securities.

Second, to discourage insider trading, the laws required every officer, director, and 10-percent equity owner to report the securities they owned. Such insiders had to turn over short-term trading profits (from purchases and sales within any six-month period) to the company. The laws provided criminal sanctions for failure to report such transactions. The SEC has zealously prosecuted the insider-trading provisions of the law and helped send offenders to jail.

Third, the 1934 Securities Exchange Act sought to eliminate the "manipulation and sudden and unreasonable fluctuations of security prices." The law prohibited several practices, such as engaging in transactions to manipulate prices or to create an illusion of active trading, making material false and misleading statements, and spreading rumors about market rigging. Stock exchanges had to register with the SEC and help enforce compliance by exchange members with the securities acts. The SEC could deny registration to any exchange that failed to comply with its rules, and it rapidly used its powers to close nine exchanges. In the late 1930s, Chairman William O. Douglas virtually threatened the New York Stock Exchange with takeover if didn't reform.

Over the years, Congress also sought to protect investors by regulating the financial institutions that manage funds. For example, the Investment Company Act of 1940 set minimum levels of diversification for mutual funds and precluded them from holding more than 10 percent of a firm's stock. Complaints about the self-serving management and underfunding of corporate pension funds led Congress to pass the Employee Retirement Income Security Act of 1974 (ERISA). ERISA prohibited pension plans from holding more than 10 percent of the sponsor's own stock or 5 percent of any other firm's stock.

Wall Street's traders, who reflexively resist any form of regulation, in fact owe a great and unacknowledged debt to rules that protect the small shareholder, mutual-fund investor, and pension-fund beneficiary. The SEC reassures the speculators—whose trading is essential to maintain the liquidity of markets—by certifying the integrity of the exchanges. Casinos with reputations for rigged games eventually drive away patrons. Penalties for insider trading similarly undergird a liquid market in which many buyers bid for stocks offered by anonymous sellers. The fear of trading against better-informed insiders would otherwise lead buyers to demand access to the company's books and to investigate the motivation of the sellers. Do they know something bad about the business or do they just need money? Without insider-trading rules, stock trades, like used-car or real-estate transactions, would probably require protracted negotiation between known parties.

Disclosure rules similarly facilitate trading of the stock of companies that neither buyer nor seller has examined from the inside. The SEC's vigorous and well-publicized prosecutions of inaccurate or incomplete statements reassure traders that they can buy stocks without independent, time-consuming audits.

The laws that protect mutual-fund investors and pension-plan beneficiaries by enjoining broad diversification of portfolios also subtly contribute to market liquidity. The more investors diversify, the more fragmented the stockholding of any firm. And fragmented stockholding promotes liquidity by increasing the odds of a trade because someone needs the money or believes that a stock is mispriced.

The historical evidence suggests that, without regulation, stock markets would be marginal institutions. Financial markets in Europe and the United States developed around debt, not equity. "Prior to 1920," Jonathan Baskin (1988, 222) writes, "there were no large-scale markets in common stock. . . . Shares were viewed as akin to interests in partnerships and were simply conveniences for trading among business associates rather than instruments for public issues." Promoters of canals and railroads—the few businesses organized as joint-stock companies—restricted ownership to known investors whom they believed to be "both wealthy and committed to the enterprise." The public at large perceived equities as "unduly speculative," and "tales of the South Sea fiasco evoked instant horror" (216).

Public markets for high-quality *bonds*, however, can be traced back to the 1600s. The first financial instrument to be actively traded in Britain was the national debt, and in the United States, as well, most publicly traded securities consisted of government issues until 1870. Later, railroad debt became popular, and, at the turn of the century, preferred issues financed the great merger wave. It is noteworthy, too, that, unlike the public-equity markets, which would evaporate for long periods following speculative bubbles, debt markets bounced back from serious crises.

The contribution of U.S. regulators to the growth in equities markets can also be inferred from the historic illiquidity of European markets, where restraints on insider trading, disclosure requirements, and manipulative practices were traditionally weak. In the Belgian market, described in 1984 as "a sad, largely deserted place" (Bertoneche 1984), insider trading was considered unethical but not illegal. Most other countries in Europe did not have statutes against insider trading until the mid-1980s, when the European Community directed member countries to adopt a minimum level of shareholder-protection laws. U.S. occupation forces instituted laws against insider trading in Japan after World War II, but officials exercised "benign neglect" of the rules.[4] And indeed, as American-style securities regulation and enforcement caught on in the rest of the world, the liquidity of stock markets around the world also improved.

Mass Equities Markets and Out-of-Control Capitalism

Unfortunately, there is a catch to the rules that sustain stock-market liquidity: they also drive a wedge between shareholders and managers. Instead of yielding long-term shareholders who concentrate their holdings in a few companies where they provide informed oversight and counsel, we see diffused, arms-length stockholding. Pension- and mutual-fund rules that require extensive diversification of holdings similarly make relationships with a few managers unlikely. ERISA further discourages pension managers from sitting on boards, for if the investment goes bad, Labor Department regulators may make them prove they had expertise about the firm's operations. Concerned about overly cozy relationships between unscrupulous fiduciaries and company managers, the regulators have effectively barred all but the most distant relationships.

Similarly, the insider-trading rules place special restrictions on investors who hold more than 10 percent of a company's stock, serve on its board, or receive any confidential information about its strategies or performance, and require them to report their transactions, forfeit short-term gains, and try to avoid any hint of trading on inside information. But why should investors become insiders and be subject to these restrictions just so that everyone else can enjoy the benefits of a level trading field? They don't: institutional investors with fiduciary responsibilities usually refuse to receive any private information from managers. They may grumble about a firm's performance, but they will not sit on its board for fear of compromising the liquidity of their holdings. Institutions also make sure they stay below the 10 percent ownership limit that puts them under the purview of insider-trading restrictions. The rules thus make large investors resolute outsiders. In a free-for-all market, the same institutions would likely demand access to confidential information before they even considered investing.

Disclosure requirements also encourage arm's-length stockholding. For example, rules that mandate the disclosure of transactions with insiders make a firm's banks, suppliers, and customers less willing to hold large blocks of stock or serve on boards. Disclosure rules also make anonymous shareholding safe. If companies' reports were sketchy or unreliable, shareholders would likely demand an inside role and ongoing access to confidential information.

Market liquidity itself weakens incentives to play an inside role. All firms with more than one shareholder face a free-rider problem. The oversight and counsel provided by one shareholder benefits the others, with the result that all of them may shirk their responsibilities. This is particularly relevant if a company faces a crisis. In illiquid markets shareholders cannot run away easily and are forced to pull together to solve any problem that arises. But a liquid market allows investors to sell out quickly and cheaply. In economist Albert Hirschman's terms, investors prefer a cheap "exit" to an expensive "voice."

Diversification rules that cause institutions to fragment their portfolios and the stockholding of the firms in which they invest compound the free-riding problem. The chance that a 20 percent stockholder will expend resources for the benefit of the group is much greater than a 0.1 percent stockholder doing so.

Thanks to these extensive rules, transient outsiders now own a significant share of most publicly held stocks in the United States. The typical institutional investor's portfolio contains hundreds of stocks, each of which is held for less than a year. Institutional investors follow the so-called Wall Street rule: sell the stock if you are unhappy with management. In countries where American-style rules don't exist, aren't enforced, or have been adopted relatively recently, the situation is different. There we see large investors whose holdings are immobilized by special classes of stock, long-term financing, or other business relationships.

Richard Breeden, a former chairman of the SEC, claims that the "closed nature" of foreign governance systems "contradicts U.S. values of openness and accountability" and is "not appropriate to U.S. traditions." However, the historical evidence suggests that investor-protection rules, not deep-rooted traditions or values, have fostered the unusually fragmented and anonymous stockholding that we find in America today. Before the New Deal, investors who took an active inside role in governance played a major role in financing U.S. industry. Du Pont family money helped William Durant—and later Alfred P. Sloan—build General Motors. Investors represented by J. P. Morgan helped Theodore Vail build AT&T and enabled Charles Coffin to create the modern GE. These investors were in it for the long haul—the du Ponts fought Justice Department efforts to make them sell their GM stock—and they played an important oversight role. Pierre du Pont watched over the family investment in GM as chairman of its board; he reviewed "in a regular and formal fashion" the performance of all its senior executives and helped decide on their salaries and bonuses. Although he left the details of financial and operating policy to executives, du Pont "took part in the Finance Committee's critical decisions on important capital investments" (Chandler and Salisbury 1971, 573, 580).

Even today, investors in *private* companies continue the du Pont tradition. Partners in venture-capital firms, for instance, serve as active board members of their portfolio companies, help recruit and compensate key employees, work with suppliers and customers, and help develop strategy and tactics (Gorman and Sahlman 1989). The investment strategy of Berkshire Hathaway's Warren Buffett also suggests that Pierre du Pont's careful overseer approach conflicts more with U.S. regulations than with the traditions or values that Breeden invokes. Buffett isn't subject to the same regulatory pressures to diversify as the typical pension-fund manager; he and his long-term partner and vice-chairman Charlie Munger own well over half of Berkshire's stock. Berkshire seeks to "own large blocks of a few securities we have thought hard about," writes Buffett (1987, 83). Buffett serves as a director of the companies that constitute Berkshire's core holdings and will, in a crisis, intervene to protect his investments. For example, during the government bond-auction scandal at Salomon Brothers, he stepped in as chairman to help effect sweeping changes in management. Apparently, Buffett's large holdings of Berkshire stock (and the tax consequences of realizing gains) make him more willing than other institutional investors to submit to the liquidity-reducing rules that insiders face. His favored holding period is "forever. . . . Regardless of price, we have no interest at all in selling any good businesses that Berkshire Hathaway owns, and are very reluctant to sell sub-par businesses. . . . Gin rummy managerial behavior (discard your least promising business at each turn) is not our style" (52).

The absence of close, long-term manager-shareholder relationships that has become the norm in publicly traded companies in the U.S. has significantly impaired their governance. The basic nature of executive work calls for intimate relationships; anonymous masses of shareholders cannot provide good oversight or counsel and often evoke mistrust and hostility.

Managers are not like agents who execute specific tasks under the direction of their principals. Like doctors or lawyers in relationship to their patients or clients, they have a broad responsibility—a fiduciary one—to act in the best interests of stockholders. As with other fiduciaries, their performance cannot be assessed according to a mechanical formula. Shareholders, on the other hand, must weigh the outcomes they observe against their guesses about what would have happened if managers had followed other strategies. Losses do not necessarily establish managerial incompetence because the alternatives might have been worse. If concrete performance objectives are set, shareholders have to judge whether managers are playing games with the targets: for example, if they are meeting cash-flow goals by skimping on maintenance.

To make fair evaluations, therefore, shareholders must maintain a candid dialogue with managers. But a candid dialogue between managers and arm's-length shareholders is impossible. Practically speaking, diffused shareholders cannot have much contact with senior executives: in the typical public company, most retail shareholders have no idea who is running the company, and most institutional investors catch, at best, only an occasional glimpse of the CEO in a carefully staged road show or a presentation to analysts. Neither can managers share sensitive data with shareholders at large; indeed, managers must *conceal* strategic information from them. If a company wants to convince potential buyers that its new product is here to stay, its managers cannot reveal to stockholders that early sales have been disappointing. Managers are forced to be circumspect; they can't discuss critical strategic issues in public, and insider-trading rules discourage private communications. Almost inevitably, their dialogues with the investment community revolve around quarterly earnings-per-share estimates, even though both sides know well that those figures have little long-run significance.

How wholeheartedly managers will advance the interests of anonymous shareholders is also questionable. Basic honesty and concern for their own reputations, as well as fear of public censure, inhibit flagrant disloyalty and fraud; but the abuses that shareholders must worry about are often more subtle. CEOs who use corporate jets to fly their dogs around patently abuse shareholders. But having CEOs wait in airports for standby seats more subtly ill serves shareholders. Where and how do managers draw the line?

The identity and values of the particular people whose approval managers seek has a great influence on these choices. CEOs who want to impress other CEOs, and who have no contact with their shareholders, will find it easier to convince themselves that well-appointed corporate jets will make them more productive. Executives who know their stockholders and value their esteem will probably provide more careful stewardship. Similarly, shareholders are more likely to ascribe poor performance to managerial incompetence than to bad luck if their perceptions have been shaped by colorful reports in the press instead of personal relationships with a company's managers.

Unfortunately, thanks to the rules, American managers and shareholders now regard each other with suspicion. CEOs complain that investors are fixated on quarterly earnings and are ignorant of companies' markets, competitive positions, and strategies. Investors see many CEOs as entrenched, overpaid, and self-serving. As Peter Lynch, former manager of Fidelity's Magellan Fund, half-jokingly remarked, "I only buy businesses a fool could run, because sooner or later one will." Conversely, CEOs could well have asked how Lynch even remembered the names of the 1,000 or so stocks in which his fund invested.

The alienation of stockholders and managers makes public-equity markets an unreliable source of capital. Surprisingly, the exceptional liquidity of U.S. markets apparently does not compensate for the problems that come with issuing equity shares. Thus, American corporations are no different from the large public corporations of other major industrialized nations in issuing common stock to raise funds "only in the most exigent circumstances," and "the quantity of funds raised by new equity issues—especially by established firms—appears to be relatively insignificant" in all countries, regardless of the liquidity of their stock markets (Baskin 1988, 213). The stock market does, on occasion, allow firms in fashionable industries to issue stock at lofty prices. But such instances usually represent episodes of "market mania," which underwriters call "windows of opportunity." When the window closes, investors dump the stocks wholesale and don't give the category another chance for a long time.

On the downside of issuing shares, arm's-length stockholding subjects managers to confusing signals from the stock market. It isn't that Wall Street is short sighted—in fact, the market often values favored companies at astonishing multiples of their future earnings. But companies fall in and out of favor unpredictably: the market abruptly switches from a rosy long-term view of biotechnology to a fascination with Internet companies. Understandably so, for without inside knowledge of companies' strategy and performance, investors have little choice but to follow the crowd.

Managers, in turn, pursue strategies to protect "their" companies against apathetic or fickle investors. Uncertain about access to capital when the firm might need it, managers avoid paying out earnings to stockholders even when it does not. They reinvest profits, sometimes in marginal projects, and outside shareholders can do little about the situation.

In the 1960s, for example, managers of cash-rich companies in mature industries made acquisitions in businesses that were unrelated to their core capabilities. The result was many conglomerates of unmanageable size and diversity. As historian Alfred Chandler (1990) observes: "Before World War II, the corporate executives of large diversified international enterprises rarely managed more than 10 divisions. . . . By 1969, many companies were operating with 40 to 70 divisions, and a few had even more." Top management often had "little specific knowledge of or experience with the technological processes and markets of the divisions or subsidiaries they had acquired." In more recent periods, the managerial propensity to retain earnings has led to investment in businesses that should be shrunk. "In industry after industry with excess capacity," Michael Jensen (1993) writes, managers "leave the exit to others while they continue to invest," so that they will "have a chair when the music stops." Thus, the workings of a stock market that supposedly facilitates capital flows actually helps immobilize capital within companies.

Investor indifference and hostility are also reflected in operating inefficiencies. Apparently, many managers don't try very hard to please anonymous shareholders. Several studies have documented dramatic improvements in profit margins, cash flows, sales per employee, working capital, and inventories and receivables after leveraged buyout transactions that replaced diffused public stockholders with a few private investors.

What about the so-called "market for managerial control"? How can CEOs who provide poor stewardship survive the unsolicited tender offer, which supposedly represents "the most effective check on management autonomy ever devised" (Rappaport 1990)?

Actually, unsolicited tender offers comprise a tiny fraction of takeover activity. Most mergers are friendly affairs, negotiated by executives of established companies seeking well-managed, profitable targets for which they are willing to pay premium prices. The managerial club frowns on hostile offers. The few profit-motivated raiders serve as a check only against flagrant incompetence and abuse. This is because they operate under significant constraints. They have to raise money, much of it in the form of high-yield debt, deal by deal, making their case from publicly available data. Even at their peak, in the mid-1980s, raiders posed a threat only to a small number of targets: those diversified firms whose break-up values could be reliably determined from public data to be significantly higher than their market values. They could not and did not go after turnaround candidates any more than friendly acquirers do.

Outside shareholders, analysts, and takeover specialists cannot easily distinguish between a CEO's luck and ability. Again, Warren Buffett, because he was a director and major investor in Salomon Brothers, could much more easily assess the culpability of Salomon's CEO and the consequences of replacing him than outside shareholders could. Judgments of managers are necessarily subjective and require considerable confidential and contextual information.

By contrast, the case of IBM dramatizes the inadequacies of external scrutiny. Between the summers of 1987 and 1993, IBM stock lost more than 60 percent of its value while the overall market rose by about the same degree. The magnitude of IBM shareholders' losses was comparable to the GDP of several OECD countries. But while its stock price relentlessly declined, IBM management did not face the least threat of a hostile takeover or proxy fight. Outsiders had no way of knowing whether managers were struggling, as competently as they could, with problems beyond their control. Ultimately IBM fortunes turned—not because of a new strategy demanded or imposed by a raider, but because of the fortuitous appointment of Lou Gerstner as its CEO.

Banks and other financial service firms, it is important to note, are virtually immune to even the limited restraints imposed by hostile takeovers. As mentioned, raiders use high-yield debt (aka "junk") to finance their takeovers. But relying on a bank's "unused" debt capacity to take it over is difficult, because most banks are already very highly leveraged: they have just a small sliver of equity in their capital structures. The takeover of a financial institution also has to be approved by bank regulators, and they will not approve a transaction that involves loading on more debt. As a result, there is no recorded instance of a large U.S. financial institution that has been the target of a serious tender offer by a raider. Bank CEOs usually lose their jobs only when calamitous performance has forced their boards of directors into action.

Another noteworthy consequence of the reassurance provided by the rules (and academic theories) encouraging diversification has been the increase in what is euphemistically called market "breadth." Differently put, in the 1980s and 1990s, the ranks of publicly listed companies were swollen by businesses that simply didn't belong. After 1979 IPOs increased from about 140 to nearly 600 per year, a process that culminated in the Internet bubble, when companies with no profits and tiny revenues famously went public. But it wasn't just dot-coms. Investment banks such as Salomon Brothers, Morgan Stanley, and Goldman Sachs that had flourished as private partnerships also went public. After centuries of having to worry about their own capital, bankers were free to play "Heads we win, tails public stockholders lose." That became an important source of the recent crisis.