

# Whom Do Today's Financial Markets *Serve?*

BY EVERETT M. EHRLICH AND MICHAEL D. MANN

*Time for a  
fundamental  
discussion of our  
vision of markets.*

America's financial markets have changed. They once served to generate wealth; today, they are more concerned with rearranging it. Their added volume once offered stability; today that added volume often exacerbates manic reactions to world events. We see these changes, but are yet to accept that they demand a reassessment of the goals and strategies of financial market regulation. We attempt here to further that discussion.

After the wreckage of the 2008 crash, the Dodd-Frank Wall Street Reform and Consumer Protection Act became the capstone of the regulatory regime. It was based on the premise that, when markets fail, it was because culprits like those who enabled the 2008 debacle—both individual and institutional—were to blame. Creating stable, “good” markets meant weeding out bad apples and passing rules that tightly constrained their behavior. So Dodd-Frank limited who could trade what (starting with the Volcker Rule), defined new rules for the securitization of assets, embraced anticipatory testing, and increased capital standards, all in an effort to preclude future misbehavior that could lead to another crash.

Yet despite these new barriers to misconduct, crises persist. Last year, exchange traded funds, the most rapidly growing segment of the equities market, were left without a workable pricing mechanism in the absence of

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sufficient liquidity in their underlying securities. And this year has seen further chaos in currency, commodity, and securities markets, driven by wild investor responses to Brexit, the mystery that is China, and a precipitous drop in oil prices. Defenders note that all these events bring new information that provides grist for the market's mill. But there can be no denying that they are also a trigger for the type of manic gyrations that give regulators pause.

As Edward G. Robinson's Pharaoh would say, where is your Dodd-Frank now? That is not to make a final judgment about Dodd-Frank's individual strictures. But all of these incidents lacked the identifiable culprits upon whose existence Dodd-Frank was based, and remind us that a search for "good guys" and "bad guys" in the market will not avoid future disruptions. Instead, these events are a reminder that today's markets have evolved in directions that transcend the conventional regulatory framework on which Dodd-Frank is premised, at the prospective cost of market stability.

The political season has cast a spotlight on this and related issues. Some see Dodd-Frank as an example of unnecessary regulatory overreach (leaving aside how they would instead prevent new crises from occurring). Others want to bring back Glass-Steagall (despite its irrelevance to the mechanics of the 2008 crash). Still others want to "break up" the big banks (without thought to the way in which this would be done, the sector's future efficiency, or its possible effects on counterparty risk). But before we begin yet another round of separating the black hats from the white, we should consider the fundamental premises that underlie regulation regarding the role of today's capital markets in the economy. That is, what job do we want markets to do, and are they doing it?

Back in the days of a different "Dodd"—David Dodd, who with his co-author, Benjamin Graham, published the revered text *Securities Analysis* and introduced the concept of "value investing"—markets existed to channel capital to its most productive uses by pricing companies and their securities. American markets were the envy of the world because, through reporting and listing standards and other regulatory safeguards, investors could participate in this fundamental exercise. This produced liquidity, which improved the pricing function, which dramatically reduced the cost of capital, with ensuing benefits for the U.S. economy. Regulators were tasked with overseeing this process by promulgating rules and standards that mandated transparency by issuers and ensured fairness for all market participants. That markets made some people rich was collateral to this central economic function.

But today, markets do far more than value the securities issued by individual companies. Under the banner of

"risk management" and "arbitrage," markets now reflect something other than the valuation of companies; they are host to an ongoing series of referenda on broad fears and trends. And while derivatives and synthetic products were once created to further the price revelation function and to hedge the risk associated with holding a specific company's securities, they are now generally traded in

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multiples that far exceed the actual value of the securities themselves. As a result, pricing today has less to do with transparency and fundamental value, and much more to do with the thundering herd's widely disparate sentiments.

These realities shake the premises of financial market regulation. Instead of efficiently pricing the value of specific companies and assets, the superstructure of derivatives and synthetics—now standardized and tradeable by almost any investor at low costs—enables market participants to wager on underlying global economic events. The liquidity they offer plays little if no role in the traditional cycle of better price discovery, lower capital costs, and greater economic growth and social welfare. Instead, our markets are characterized by hyperliquidity, in which the value of representative financial interests grows faster than the assets on which these financial interests are predicated, giving rise to unanticipated and sometimes feverish swings in sentiment, as "investors" try to adjust and realign their risk to precipitously changing opinions.

Yet despite these profound changes in the role of markets in economic growth, our expectation remains

*Continued on page 86*

*Continued from page 53*

that a day in which markets don't crash is a good one; we congratulate ourselves if it doesn't and see regulation as a success, even as those crashes and disruptions become more frequent. Meanwhile, our current obsession with identifying the culprits behind market instability distracts us from the more relevant question of what it means to say that our markets "are working." The metaphor of a "casino" is often overused when talking about our capital markets, but there can be no denying that our current policy regarding the role of markets is that "anything goes," and that regulators and legislators are now almost entirely focused not on the market's function in the process of economic growth, but merely on ensuring that the "house" remains open.

Today's markets are no longer primarily devoted to the creation of wealth through the traditional virtuous circle of liquidity, pricing, and capital generation—they are now primarily engaged in rearranging it. And while rearranging society's wealth earns many a good living (and, in fact, may be an important source of the growing inequality that now hampers growth), we are fooling ourselves if we think that kind of market can provide the same suite of benefits they once did. These are issues that Dodd-Frank—and Glass-Steagall for that matter—don't begin to ask. Those laws concern themselves with who is allowed to do what. Our view, to the contrary, is that it is time consider what will be allowed rather than who will be allowed to do it. And, specifically, there needs to be a line drawn between legitimate risk management and open speculation.

Drawing that line raises a host of difficult questions. If liquidity floods into derivatives but not underlying securities, does it at some lead to more volatility rather than better price discovery? Should we—and can

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we—judge various financial products by their potential to destabilize markets and, therefore, their systemic "social" costs? Must an investor have an asset worth "insuring" before she can purchase a product that provides "insurance?" Are there potentially destabilizing effects associated with high-frequency trading (now two-thirds of all activity) and are those trading practices priced correctly? And, most fundamentally, how would

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we define trading limitations that are enforceable and that strike the right balance between assuring market stability and allowing individual freedom?

None of these questions is simple but, in our view, they are all unavoidable. For if we do not begin this search for balance, the prospect of market crises will continue to pose a risk to the entire economy and all its participants, while the benefits derived from our markets' "wealth-rearranging" function will accrue to a very few.

We hear much today about individual institutions being "too big to fail." Here is the undeniable reality—capital and financial markets themselves are too big to fail, too important to our daily livelihoods, too fundamental to every economic pursuit. And if there are activities that endanger markets or threaten the significant benefits these markets are expected to engender, that are inconsistent with the market's central function of directing capital in ways that promote economic growth, then those activities require reconsideration.

Will our political leaders lead such a discussion? Perhaps not, at least now. Our leaders are either entranced by the market's Sphinx-like neutral intelligence on the one hand, or want to play Cotton Mather to the witchcraft of malevolent banks on the other. Maybe, several crashes from now, someone will get the message. For we must at some point have a discussion among policymakers, regulators, and market participants themselves regarding our vision of the markets, much as the two dozen visionaries did to our great benefit, under the buttonwood tree, two-and-a-quarter centuries ago. ♦