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CONFRONTING COIN-FLIP CAPITALISM

A Pro-Market Agenda for Financial Reform

Oren Cass

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Executive Summary

This paper presents the case for policymakers who favor free markets and appreciate the value of a well-functioning financial system to reform the rules governing that system—refashioning the bankruptcy process, instituting new restrictions and taxes on unproductive transactions, and requiring broad disclosure of private-fund activity. The progressive approach encapsulated in Senator Elizabeth Warren's Stop Wall Street Looting Act (SWSLA) is unnecessarily prescriptive yet ultimately does not go nearly far enough.

I begin by describing dysfunction in today's financial markets in terms of three misallocations:

A. Capital: American financial markets are not doing an effective job facilitating investment in the real economy. Net business investment as a share of GDP has been declining for decades and major corporations are increasingly choosing to disgorge their profits back to the financial sector rather than invest them in maintaining and growing their capital stock.

B. Talent: A disproportionate share of top business and engineering talent is flowing into the financial sector in pursuit of the outsized profits available to money managers regardless of the value they create. This creates a vicious cycle in which business leaders pursuing promising opportunities become harder to find, further encouraging the financial sector to develop strategies for deriving profits disconnected from actual investment.

C. Risk: The diffuse and anonymous ownership of the modern corporation encourages increased risk-taking and leverage, tolerating the distress and collapse of some firms in exchange for greater returns at others. The workers and communities relying on particular firms have no such luxury of diversification. And while they face increased risk, they see no offsetting benefit in terms of higher rewards.

Compounding these misallocations is the emergence of enormous pools of capital in public pension funds and nonprofit endowments that are imbued with public purpose, subsidized or backstopped by taxpayers, and managed by committees with poorly aligned incentives. This capital has flowed increasingly to "alternative investments" and now represents the largest source of capital for both private equity and hedge funds. The standard free-market assumptions that (a) investors allocating their own capital will do so well, and (b) those who do not will face the consequences themselves, simply do not apply. And sure enough, these investors appear to be selecting excessively risky and illiquid assets that deliver subpar returns while collecting excessive fees.

After reviewing the shortcomings of both the left's Stop Wall Street Looting Act and the right's blind faith in markets as they operate today, I propose a series of reforms intended to:

A. Align Risk and Reward.

1. Create a new, primary obligation to workers that is paid first in the event of a bankruptcy. Workers laid off in advance of or during a Chapter 11 reorganization, or in a Chapter 7 liquidation, should hold a substantial claim on the firm's assets senior to those of creditors. The proposal here contemplates payment equal to six months' salary.

2. Eliminate the deductibility of interest. The tax code should remove its subsidy for debt, instead placing debt and equity financing on equal footing. Both equity and debt play an important role in corporate finance and most firms will require some balance of each, but a distortion on the current scale makes no sense, especially when the result is to embed much greater risk in the system at workers' expense.

B. Increase Information.

1. Require pre-registration of public benchmarks. Private funds should be required to include upfront identification and public disclosure of appropriate benchmarks (based on asset type, risk profile, etc.) that the fund proposes to outperform.

2. Require self-capping of fees. Private funds should be required to declare a total expense ratio, representing the maximum in fees they will collect annually and over the life of the fund, and then report on fees collected each year.

3. Require public release of annual performance. The SEC should establish financial reporting standards for private funds, which should be required to publish comprehensive financial statements on an annual basis, including the timing and amount of all cashflows into and out of the fund, deal size and structure for all transactions, and annual marked-to-market valuation for each asset held in the fund.

C. Reduce Financial Engineering.

1. Apply an economic activity test. Firms seeking to list their shares on a public exchange should be required to demonstrate in their filings that those shares represent an economic interest in a going business concern. Speculative mechanisms for placing leveraged bets and SPAC-like cash grabs for deployment at a later date should not qualify.

2. Ban buybacks. The SEC should repeal Rule 10b-18, promulgated by the Reagan Administration in 1982, which legalized corporations trading in their own stock. Firms can return cash to shareholders via dividends whenever they want.

3. Impose a financial transaction tax. The seller of a security on an American exchange, or where either buyer or seller is based in the United States, should be charged a tax equal to one-tenth of 1% of the transaction's value (10 basis points). Other measures to make actual investment in the real economy more attractive should offset the revenues from this tax and from the elimination of the interest deduction described above.

Introduction

In July 2020, investors gave $4 billion to hedge-fund titan Bill Ackman for, in his words, a "unicorn mating dance." The pony they'd picked was Pershing Square Tontine Holdings Ltd., a "Special Purpose Acquisition Company" (SPAC) that would use the funds to buy a real company to be named later. Thus began what the *Wall Street Journal* described as "one of the biggest guessing games on Wall Street." Ackman "egged on [investors] by frequent public pronouncement about the mystery deal" and it became "a popular bet for individual investors, who piled in … and had speculated that Mr. Ackman would take public a splashy startup."

The eventual deal, announced in June 2021, is a convoluted "feat of financial engineering" that buys no company and "isn't what investors expected," observed the *Journal*. Instead, it "frees Mr. Ackman from the two main constraints of SPACs" and creates "a new cash box that the market doesn't fully understand," giving him "considerable firepower for more deal making." Investors, meanwhile, "puzzle over the transaction and the billionaire's next moves" and "get rights to buy shares of a novel vehicle called a special-purpose acquisition rights company, or SPARC." Perhaps they should have paid closer attention to the definition of "Tontine," a financial scheme in which everyone pays in and "the beneficiaries are those who survive…"

Presumably, Ackman is not committing fraud in the legally cognizable sense. But his stunt rests squarely in the not-so-proud tradition of financial alchemists marketing products that serve mainly to generate profit for themselves while shifting risk onto less sophisticated parties or, even better, onto third parties with no say in the deal. The sorry spectacle offers a valuable reminder that much of the financial sector's activity has nothing to do with its primary functions of allocating capital to productive uses and disseminating information through price signals. Most transactions merely exchange asset piles, often at prices that prove woefully disconnected from actual value.

It's hardly news that people are in the market to make money rather than to serve a useful social and economic purpose. The assumption underlying capitalism is that by pursuing profit people will allocate their resources in ways that prove socially valuable; this is the premise of Adam Smith's "invisible hand." But the assumption of an alignment between profitable and useful activities is just that: an assumption, which holds only for well-functioning markets.

Financial markets do not exist in nature, with passers-by in the forest pausing to exchange credit default swaps and leverage their holdings of distressed debt. Public policy creates the markets, governs them, and through its choice of rules shapes their contours and outcomes. Indeed, Smith warned that the interest of holders of capital who "live by profit" is "always in some respects different from, and even opposite to, that of the public" and that their policy preferences should be examined "with the most suspicious attention." Markets vary widely and the rate of profit "is always highest in the countries which are going fastest to ruin."

The rate of profit for those who work on Wall Street is today very high indeed.

I. Misallocations in the Modern Market

The issue for policymakers is not financial foolishness, per se. No one needs to protect “high-net-worth individuals” from frittering away their money in “value”-focused hedge funds that catastrophically underperform simple market indices year after year. But financial markets hold a unique place in a capitalist economy and their effectiveness in allocating resources is everyone’s concern. A dysfunctional system presents at least three problems of misallocation:

A. Capital. A well-functioning financial system plays a vital role in moving capital to those who need it and can use it most productively. Operating businesses pay for access to that capital, both delivering a return to those who provide it and a fee to those who facilitate its transfer. But typically, an operating business’s use of such services would be limited to its start-up, when it must invest before it is profitable, and to situations where an infusion of capital is needed to finance a major new initiative or overcome a crisis. A sustainably profitable business is, by definition, generating sufficient cash from operations to (1) fund the investment necessary to maintain or grow its capital stock, and (2) return a profit to the shareholders who are the owners of the capital that the business uses.

That was historically the norm, but it is not any longer. Research by American Compass has shown that, from 1971–1985, businesses operating in this sustainable form (“Sustainers”) accounted for 82% of market capitalization on public exchanges. By contrast, businesses that had sufficient profit to operate as Sustainers but chose instead to underinvest in their own capital stock and return more profit to shareholders (“Eroders”) accounted for just 6%. By the 2010s, Eroders had surpassed Sustainers; in 2017, Eroders were 49% of market capitalization while Sustainers were 40%. The share of GDP flowing out of public companies and into financial markets had more than doubled.

Some defend this extraction of capital from operating businesses back to the financial sector by arguing that the sector then reallocates it to other, more productive investments. Unfortunately, this is not in fact happening. Nationwide, net investment as a share of GDP has fallen sharply, and the shortfall since the Great Recession totals roughly $3 trillion (equivalent to the excess outflow from public companies). From 2009 to 2017, the nation needed $22.9 trillion in gross investment to match the average growth rate of the capital stock during 1970–99 (3.8% of GDP annually). Instead, investment totaled only $19.6 trillion.

Other indicators also depict a financial system failing in its vital task. Investment in new firms via venture capital, the nation’s vaunted engine of entrepreneurship and innovation, offsets less than 5% of the public-company outflow and is concentrated overwhelmingly in a narrow set of industries (software and the life sciences) and regions (the West Coast and the Northeast). Business formation in general has slowed, and likewise concentrates itself in an ever-narrower set of places. In theory, the combination of robust financial markets, trillions of dollars in uninvested corporate profits, and rock-bottom interest rates should be lowering the cost of capital for firms. But they report no such opportunity and, to the contrary, report a willingness to invest only in projects that they foresee delivering exceptionally high returns.

B. Talent. The sheer scale of wealth flowing through the economy's plumbing creates opportunities for profit far out of proportion to economic value. The financial sector's share of corporate profits, once less than 10%, reached 40% in the early 2000s and has remained consistently above 25% since.

Business talent has followed. Graduates of America's top business schools provide a useful proxy for the attraction of various industries and, from 2015 to 2019, nearly 30% of graduates from Harvard, Stanford, Wharton, Booth, Kellogg, Columbia, and Sloan went into finance. In 2020, the finance industry was the most popular and offered the most generous compensation packages for graduates of the MBA programs at both Harvard and Stanford.

Engineers have likewise flocked to Wall Street, as compensation at equivalent education levels surged in finance as compared to engineering after 1980. The probability of an engineer switching to a finance career increased more than four-fold from the 1980s to the 2010s; the share of "STEM" jobs in finance doubled over that period while the share in manufacturing fell by half. Lest one think these are the engineers who couldn't hack it in engineering, Nandini Gupta and Isaac Hacamo of Indiana University's Kelley School of Business find that "financial sector growth attracts exceptionally talented engineers from other sectors to finance."

As talent drains from the real economy, a vicious cycle also gets underway in which business leaders pursuing promising opportunities become harder to find, further discouraging productive investment. "Financialization could have a suppressive effect on potential entrepreneurship by draining away human capital," note the Kauffman Foundation's Paul Kedrosky and Dane Stangler. "Conversely, an underlying decrease (or, at least, not an increase) in entrepreneurship creates a shortage of new financing opportunities for the financial sector, meaning the sector must find other outlets in which to be innovative and make money from money—causing the sector to expand." They estimate that if the finance sector shrank to its 1980s scale as a share of GDP, the rate of entrepreneurship would likely increase back to its 1980s rate as well.

C. Risk. Much financial engineering aims to convert the real economy's activity into derivative products with risk-versus-return profiles that will appeal to particular classes of investors. This has some value, where the result is to spread risk among parties who choose how they wish to participate. For instance, some investors may wish to hold a firm's equity while others might prefer its debt. Unsurprisingly, though, the engineers find it especially attractive to design products that shift risk onto third parties while keeping returns for themselves. This happened on an economy-wide scale in advance of the 2008 financial crisis, where speculators took irresponsible risks that generated huge returns when the coin landed "heads," but third parties and then taxpayers found themselves on the hook when the coin landed "tails."

A similar, but less appreciated phenomenon is at play in modern models of business ownership. In theory, shareholders, managers, and workers all have a strong interest in a business's solvency. Bankruptcy would wipe out the first, humiliate the second, and leave the third unemployed. Historically, a business's owners and managers often lived in the same community with their workers and suppliers, supported its institutions, and relied on it as much it relied on them.

Disparate ownership of publicly traded companies has severed many of these bonds, leaving most shareholders indifferent to the fate of any particular holding. Whereas American households held more than 90% of the nation's publicly traded equities at the end of World War II, most are now held by pension funds, mutual funds and ETFs, alternative fund managers, and foreigners. Anyone who holds broad-market index funds or a managed retirement account was likely an "owner" of a business that went bankrupt last year or got sold for parts, but almost certainly does not know or care. It may well be in investors' interest for businesses to take on higher levels of debt that generate higher profits for shareholders in the good times and more bankruptcies in the bad. Managers provide at least some check on this impulse. Though in theory they should do the bidding of their shareholders, in practice they are likely to have greater concern for the business's survival—their own success remaining closely tied.

The capitalists applauding themselves as "risk takers" deserving of their rewards are not the ones facing the real risk.

The leveraged-buyout model employed by many "private equity" (PE) firms represents a hybrid case. On one hand, the strategy calls explicitly for incurring high levels of debt that enable much larger profits when a transaction is successful, accepting that some bankruptcies will occur along the way. Targets of leveraged buyouts are ten times more likely to go bankrupt. PE firms also have the benefit of playing with someone else's money under agreements that promise them a share of any gains while insulating them from any losses. They will often import managers whose primary allegiance is to the PE firm's success, not the operating business's success. On the other hand, PE firms keep much closer watch on their holdings than the typical passive investor might. Their interest is relatively more concentrated in fewer businesses. And they operate on longer time horizons, typically seeking returns over several years rather than the next quarter.

Thus, while the PE model certainly produces some of the worst abuses, it represents only part of the problem. Highly leveraged businesses, regardless of their owner, are more likely to slash employment in the face of an economic downturn. A strategy that imposes high risk on a number of businesses, with the expectation that higher returns from some will compensate for failure at others, may be smart for the manager of a PE fund, or for institutional shareholders writ large. But it can also leave a catastrophic human toll in its wake. The capitalists applauding themselves as "risk takers" deserving of their rewards are not the ones facing the real risk.

II. We Are All Private-Equity Investors Now

All three problems of misallocation are compounded by a fourth that has emerged in recent years: mismanagement of the $5 trillion in assets controlled by state and local pension systems. Colloquially, these systems hold assets on behalf of pensioners who have been guaranteed payment in retirement. But because that payment is guaranteed by state and local governments, it is actually the taxpayers, not the pensioners, whose interests are at stake and whose money is being managed. If pension funds perform well, the systems will have more resources available and fewer tax dollars will be needed; if they perform poorly, taxes must go up further or other government services must be cut to make up the difference.

These systems have piled their capital into "alternative investments" and now have the largest stakes in both PE and hedge funds. Unfortunately, both asset classes exhibit the characteristics of Coin-Flip Capitalism, generating quite random returns that perform on average no better (and often much worse) than basic public-market indices. PE has struggled to match public benchmarks for the past 15 years, firms show little ability to replicate their success from one fund to the next, and investors no longer earn the premium they should expect for investments with PE's characteristics. Hedge funds have woefully underperformed their own benchmarks and, when volatility struck at the outset of the COVID-19 pandemic, they proved to be not much of a "hedge" after all.

Defenses of the industry's poor performance typically rely on an appeal to market efficiency: if the money keeps coming in, the fund managers must be doing something right. And if the fund managers earn massive profits, they must be creating value. But when the capital originates from public pension systems, or the similarly situated nonprofit endowments sitting on an additional $2 trillion of capital, this logic does not hold.

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Public pension systems rely on industry consultants to advise relatively unsophisticated managers hired by politically chosen overseers, none of whom have interests aligned particularly well with good stewardship of the resources or the interests of taxpayers. Corruption is rampant. The two largest pension systems, in New York and California, have both dealt in recent years with bribery scandals that brought down the former's state comptroller and the latter's chief pension executive.

The Institute for Pension Fund Integrity reports that only five of 52 state pension systems managed to outperform a basic 60% equities, 40% bonds portfolio over the past decade, with overall underperformance of about 100 basis points per year. For endowments, the annual underperformance was about 150 basis points. A greater allocation of capital to "alternative investments" like PE and hedge funds is correlated with worse performance. Assessing the $230 billion in management fees collected by PE firms during the past decade, Oxford University professor Ludovic Phallipou concluded that this "wealth transfer from several hundred million pension scheme members to a few thousand people working in private equity might be one of the largest in the history of modern finance."

Researchers have developed a fascinating and persuasive theory to explain this folly: private funds like PE, hedge funds, and venture capital offer features unrelated to their returns that make them attractive to pension and endowment managers. First, the funds are illiquid, meaning that the manager can't buy and sell at will. Once the money is committed to the private fund, it stays there for years. Second, the assets in the private funds are difficult to value, so no one knows how volatile they are or how well they are performing.

Usually, these would be negatives; investors like to have access to their money and know how much they have, and they should expect especially high returns if they must lose that access for long periods of time. Historically, the rule of thumb for portfolio managers was that, to be successful, an illiquid asset like PE should generate at least a 300-basis-point premium over a liquid alternative, though the California state pension system somewhat comically reduced its target from 300 to 150 basis points in 2018 after failing to hit the higher figure. A good illustration of the undesirability of inaccessible funds came in 2020, at the outset of the COVID-19 pandemic. Universities sitting on massive endowments nonetheless found themselves forced to make steep cuts because, as Hoover Institution economist John Cochrane noted of Stanford:

> Everyone wants to be a hedge fund. Borrow short and cheap, invest in illiquid, high-fee, actively managed, cyclically sensitive securities. Report great returns. And, in the downturn, carnage ensues. I would be kinder about this if we had not gone through this a mere 12 years ago. … Like everyone else in America, universities went right back to the hedge fund with a football team model. And here we are again. Budgets evaporating. And firing people, cutting wages, and missing opportunities.

So, what's the upside? "This," explains a Morgan Stanley report, "is where psychology comes into play. Private equity funds do two things that may benefit investor returns. First, the capital is locked up for a period of time, which limits the ability to buy high and sell low. Second, the smoothed returns provide a perception of stability." In other words, inability to access the money prevents inept managers from behaving stupidly, and inability to value the investment accurately prevents inept managers from looking stupid. The chief investment officer for Idaho's pension system was uncharacteristically blunt: "It may be phony happiness, but we just want to think we are happy." Like the basketball team's general manager who has traded his best players

for draft picks in future years, pension and endowment managers placing other people's money in private funds buy themselves perhaps a decade before anyone can hold them accountable for poor performance.

Another factor driving poor decision-making by pension systems is their politically motivated need to deliver implausibly high returns to compensate for the underfunding of their obligations. Rather than put aside the money necessary to fund their promises, politicians pretend that their pension systems will make investments that deliver huge profits. The managers must then find alternative investment funds that claim to fit the bill. The *New York Times* captured this dynamic well in its reporting on investments by the Pennsylvania teachers' fund: "The search for high returns takes many pension funds far and wide, but the Pennsylvania teachers' fund went farther than most. It invested in trailer park chains, pistachio farms, pay phone systems for prison inmates — and, in a particularly bizarre twist, loans to Kurds trying to carve out their own homeland in northern Iraq. Now the F.B.I. is on the case…"

> The decisions that brought the fund to this point—the investigation is still in its early stages—are by now commonplace in the world of public pensions. Lawmakers years ago overpromised what the Pennsylvania fund would provide its members, even as the performance of its plain-vanilla stock and bond investments fell far short of what was necessary to deliver on those commitments.
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> That pushed the $62 billion fund into the highly risky world of alternative investments, which can sometimes pay big bucks but also cost exorbitant fees and tie up money in ventures that retail investors wouldn't touch. Despite putting an eye-popping 51 percent of assets into alternatives, the fund couldn't deliver the high returns it sought.

While industry cheerleaders with large financial stakes predictably insist that a rebound for their alternative investment strategies is imminent, neutral analyses suggest the problem is likely to get worse. As Dan Rasmussen observed in *American Affairs* in 2018, the valuations that PE firms pay and the leverage they impose have been steadily rising, producing funds with higher risk and lower reward. "The 2015, 2016, and 2017 vintage years," he predicts, "are likely to return close to zero percent per year if history is a good guide." Researchers at AQR, itself an underperforming hedge fund that has hemorrhaged investors in recent years, concluded in early 2020 that PE "faces headwinds that make it less likely to deliver the strong returns it has in the past" and attributed investor optimism to "lack of transparency on PE returns and fees, slow learning about performance, and the use of misspecified benchmarks."

III. A Partisan Blindspot

Policymakers have been derelict in their duty to maintain rules for the financial sector that would channel its activities toward its core tasks in support of the real economy. Of course, the left-of-center is awash in regulatory proposals, but these belie a fundamental distrust of markets and a preference for overriding rather than reinforcing their function. The right-of-center, for its part, errs in extending a blind trust that the market will function well even with no rules at all.

The quintessential progressive effort is the "Stop Wall Street Looting Act" (SWSLA), introduced by Senator Elizabeth Warren in 2019. SWSLA identifies a number of important issues in its findings, including the imposition of excessive debt on acquisitions, unfair treatment of workers in bankruptcy proceedings, and inadequate disclosure of private-fund fees and performance. Some of its provisions have merit. But rather than set generally applicable rules to buttress a well-functioning market, Senator Warren's approach is to identify specific activities she considers undesirable and then proscribe them. Thus, SWSLA focuses narrowly on PE firms, although the animating problems are much broader. It sets arbitrary thresholds for what constitutes acceptable levels of leverage and timelines for dividend payments. Because it takes aim at a specific class of politically unpopular activities, its main effect would likely be to encourage yet more financial engineering to recast such activities in other forms left unaddressed. SWSLA is chock full of excessive interventions and yet, ultimately, does not go nearly far enough.

For example, sections 101 and 102 attempt to hold PE firms, and the partners who run those firms, responsible for debts they place on the businesses they acquire. This has intuitive appeal but runs quickly into the reality that U.S. corporate law is premised on insulating owners from that kind of liability. One problem with trying to change the rule just for PE firms is that those firms will respond by restructuring their transactions so that they fall into some other, still immune category. A second problem is that the narrow reform leaves untouched the vast majority of cases where owners place too much debt on a company.

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The liability-assignment gambit also misunderstands the underlying issue that it seeks to address, which is presumably the harm done to workers, suppliers, customers, and entire communities when owners try to supercharge profits with risky debt but instead send a business into distress or bankruptcy. Owners (whether shareholders or, in the case of PE, fund managers) may be acting irresponsibly, but they are joined in that behavior by the creditors who extend the loans. When the risks go bad, current bankruptcy law ensures that owners lose 100% of their stake and creditors

lose some share of what they are owed. SWSLA would allow creditors to collect more from fund managers, but that would not ease the pain of the operating business going through the bankruptcy. Perversely, by reducing the losses of creditors, it would encourage them to make more such loans in the future.

Section 201's prohibition on dividend payments in the first two years after acquisition, and section 304 and 305's limits on executive compensation, provide similar examples. Problems of excessive payouts to owners and executives are hardly unique to PE deals and no clear reason exists for treating the industry differently in the matter. Section 201 also stands out for its arbitrary two-year waiting period before a PE firm can collect a dividend from a business that it has bought. It is hard to see what this would accomplish beyond prompting the PE firms to have their acquired businesses put massive cash reserves to one side and then disgorge them two years and one day after acquisition.

Worse still is section 204, which limits the deduction of interest payments from taxes owed, but only for businesses owned by PE firms and only if a measure of indebtedness called the debt-to-equity ratio exceeds one. As discussed below, limiting (indeed, eliminating) the deduction for interest payments would be a wise reform. But applying the reform only partially, only for businesses that hit particular financial thresholds, and only if they are owned by PE firms, is the quintessential progressive misfire. It adds complexity to the tax code, further distorts the incentives facing business owners, and encourages new layers of financial engineering. It will not help workers.

On the right-of-center, meanwhile, the market fundamentalist dogma that market outcomes must be good and valuable has precluded an understanding of the problem let alone the development of a response. As legendary distressed-debt speculator Howard Marks put it, "People flock to work in finance, and they make money. Thus the sector must provide something good to someone. If not, where do financial firms' profits (and their ability to provide lofty compensation) come from?" Perhaps the best illustration of this fundamental lack of seriousness is a 2019 analysis of SWSLA by the U.S. Chamber of Commerce, which warns the law could shut down the PE industry entirely, in turn leading to the loss of all 25 million jobs at every business currently controlled by a PE firm.

In the fundamentalist framework, any problems that *do* exist are unlikely to be the result of the market's failures. Rather, they must result from *too much* government involvement; the answer is deregulation. "Any suspicion that [financial market] activities give rise to negative externalities … is psychosomatic," argues George Mason University economics professor Donald Boudreaux. "Taxes and regulations create externalities … and it certainly makes no sense to ask the very people who impose these harmful interventions—politicians—to address the problem with additional interventions rather than simply to remove the offending ones."

As a theory, this is of little use where public pension systems are concerned and public officials are the ones in control of investment decisions. But more broadly, it is at odds with the empirical evidence. After decades of financial deregulation, volatility has not declined and liquidity has not improved—

to the contrary, the entire system seized in 2008 and required aggressive government intervention. Technology has continually lowered the cost of transacting, but this has spawned a "high frequency trading" (HFT) arms race in which the most technologically sophisticated investors waste untold resources competing to execute trades in shorter fractions of seconds, at the expense of the slower retail investor who is benefiting much less from "cheaper" trading than he might think.

In the fundamentalist framework, any problems that *do* exist are unlikely to be the result of the market's failures. Rather, they must result from *too much* government involvement; the answer is deregulation.

Rather than aid in "price discovery," speculators pile into momentum trades and amplify price swings. Hedge funds were heavily overweighted in hot technology stocks in the run-up to the dot-com bubble, while the practice of betting against stocks known as "short selling" was at its nadir. Hedge funds should have thrived when the market suddenly weakened in 2018, but instead they were caught off-guard. "Many computer-driven strategies rely on correctly reading market and economic trends," reported the *New York Times*, "and the strong bull-market trend ended abruptly in February, sending many surprised quant-fund managers scrambling to rewrite their algorithms." Managers of "long-short" funds did worse than the overall market, suggesting they were "worse stock pickers than most people," even in a declining market tailor-made for their approach.

Most importantly, while the speculative swapping of assets has skyrocketed, actual investment in the real economy has declined. Even the market fundamentalists—indeed, especially the market fundamentalists—recognize that higher investment levels would be beneficial. This was the premise of the 2017 Tax Cuts and Jobs Act (TCJA), after all. Except that TCJA failed to generate any response. Boosting investment will require a more robust policy effort to reorient the financial system toward that goal.

IV. An Agenda for Well-Functioning Financial Markets

Effective financial regulation has broadly applicable scope. It creates the conditions for markets to function well, leaves market actors free to pursue potentially useful economic activity, and helps to ensure that more profitable activities tend also to be those that are socially valuable.

The market's present dysfunctions point toward the need for three sets of reforms: First, better alignment of risk with reward, so that business owners and creditors who use debt to financially engineer higher returns for themselves bear more of that strategy's risk. Second, increased information, so that funds managed on behalf of taxpayers or in the public interest face stringent public scrutiny. Third, reduction in the opportunities and incentives for financial engineering, so that attention returns to actual investment.

In addition to improving the market's functioning, these approaches would reduce the excessive rents captured by speculators and manipulators. More talent would flow to other parts of the economy and the oversized financial sector might finally return to a worthwhile scale.

A. Align Risk and Reward.

Loading a business with debt is a perfectly rational strategy for shareholders who have stakes in many such businesses and can tolerate catastrophic failure in some. It is equally rational for the creditors who place many bets themselves and can recover much of what they lent even in the case of a bankruptcy. Workers, however, get the risk without the reward. They see no gains from a business incurring debt for purposes of increasing shareholder payouts; to the contrary, they are likely to see their wages and benefits squeezed. They are not diversified, with jobs at fifty other businesses that will continue paying them even if one goes under. And the downside loss is not of someone else's money on a spreadsheet, but of their very livelihood.

While PE firms are especially aggressive users of leverage, the strategy is pervasive in the private sector. Corporate debt levels stand at record highs, whether measured relative to output or earnings. Aside from the specter of bankruptcy, such debt levels leave businesses more susceptible to external economic shocks, more likely to be the source of an economic shock, and more likely to cut jobs in response. Remarkably, the U.S. tax code actively subsidizes this behavior, allowing for the deduction of interest payments to creditors as a business expense while taxing dividends distributed to shareholders as profit. Policymakers should:

> **1. Create a new, primary obligation to workers that is paid first in the event of a bankruptcy.** This could equal, say, six months' salary for all workers laid off in advance of or during a Chapter 11 reorganization, or for all workers in the event of a Chapter 7 liquidation. Officers of the company would be excluded. While owners and creditors might attempt to avoid liability by creating non-standard employment relationships, the bankruptcy process already operates under the control of a judge tasked with making fact-specific determinations. A similar claim should be created for local communities, equal to one year's tax liability in each domestic locality where a business operates. Claims of suppliers and

customers concerning goods and services already contracted should be made senior to long-term creditors as well.

The effect of these changes in bankruptcy rules would be to decrease the value that creditors can recover from a business in bankruptcy while increasing the value available to other affected parties. This would make slightly riskier all business lending (any company might hypothetically land in bankruptcy) and make much riskier the aggressive leverage strategies that accept the chance of bankruptcy as a cost of business and a means to higher returns. It would also give workers and local communities a seat at the table in reorganizations. Creditors would become much warier of highly leveraged deals, limit owners' ability to take cash out of their operating businesses, and seek other resolutions in a crisis. Where a bankruptcy occurred nonetheless, workers and their communities would still be hit hard—but not as hard; creditors who pulled the business under would be hit harder than they are today.

2. Eliminate the deductibility of interest. Interest payments should not be deductible against corporate profits, eliminating the subsidy that exists for debt and placing debt and equity financing on equal footing. The best illustration of the tax code's bias comes from a 2014 analysis by the Congressional Budget Office, which found that a corporation financed entirely by equity investment would face an overall effective tax rate of 38%, while one financed entirely by borrowing would face a rate of -6%. (The Tax Cuts and Jobs Act of 2017 would have affected these rates somewhat.) Both equity and debt play an important role in corporate finance and most firms will require some balance of each, but a distortion of that scale makes no sense, especially when the result is to embed much greater risk in the system at workers' expense.

Defenders of the deduction argue that, as a matter of principle, taxes should apply only to profits and profits are calculated after interest has been paid. This reasoning begs the question. The tax system can just as well define profit as a business's earnings before interest and taxes have been paid. Indeed, Earnings Before Interest and Taxes ("EBIT") is a standard metric reported on the income statement and is commonly referred to as "operating profit."

B. Increase Information.

Many of the nation's largest asset holders bear little resemblance to the private investor who is generally assumed to be allocating capital. State and local pension systems are the most obvious example, with their array of conflicting and often noneconomic incentives, the constraints on their ability to recruit talented managers, and the explicit taxpayer obligation to compensate for any losses. The endowments of major foundations and nonprofit institutions, including universities, are a second case—granted tax-free status and presumably operated for the benefit of the public, even as many have mutated into badly managed hedge funds. Sovereign wealth funds are a third, different but still relevant case. They are controlled by foreign governments and thus face many of the same political challenges afflicting public pension systems. On one hand, this is less concerning because American taxpayers are not the ultimate losers. On the other hand, foreign political control introduces an added concern as governments use

their capital to pursue their own political and economic goals inconsistent with American interests.

Policymakers should mandate marketing and public reporting standards for the private funds that ingest, invest, and collect fees on much of this public-purpose capital. One objective of this mandate would be to aid public pension systems and nonprofit endowments in allocating their capital, minimizing the fees they are charged, and holding funds accountable for results. A second would be to facilitate public scrutiny of the allocation decisions made by these investors as well as by sovereign wealth funds, and of the way private funds ultimate deploy the capital. SWSLA's section 501 lists a number of public disclosures that would be valuable. But for private funds marketing themselves to and accepting capital imbued with a public purpose, policymakers should also:

1. Require pre-registration of public benchmarks. Evaluating a private fund's performance requires comparing it to a public-market equivalent that someone might otherwise have chosen. The process of raising money for a fund should include upfront identification and public disclosure of appropriate benchmarks (based on asset type, risk profile, etc.) that the fund proposes to outperform. One might expect the fund to simply choose easily beatable benchmarks, but that would undermine its claim to delivering the high returns that are supposedly available only from alternative investments. Funds would have to choose between setting reasonable expectations (forcing pension managers, for instance, to admit that their allocations would not deliver on politicians' demands) or setting unreasonable ones (against which their performance could then be measured, and fees calibrated). Either way, transparency and accountability would be vastly improved.

2. Require self-capping of fees. The publicly traded PE firms, KKR, Carlyle, Apollo, Blackstone, and Ares, report generating most of their revenue not from the returns on their investments but from fees charged to their investors and acquisitions. At the latter three, more than two-thirds of revenue comes from fees. Oxford's Phallipou estimates that the typical PE firm collects yearly fees equal to approximately 7% of the fund's value. Over a ten-year fund life, the majority of the initial investment will be taken out by the PE firm.

Investment vehicles like mutual funds are required to advertise their "total expense ratio," which reflects the sum of all fees charged to investors each year as a share of the total amount they have invested. Private funds should likewise declare a total expense ratio, representing the maximum in fees they will collect annually and over the life of the fund, and then report on fees collected each year. Private-fund fees take a number of forms including management, carry, transaction, monitoring, and consulting, charged sometimes to the investors and other times to the acquired businesses. Each of these should be enumerated in the total expense ratio and in annual reporting. Funds could choose to leave their share of investment profits (the "carry") uncapped but would still report its amount.

3. Require public release of annual performance. The SEC should establish financial reporting standards for private funds, which should

publish comprehensive financial statements on an annual basis. For effective evaluation of performance, these statements should include the timing and amount of all cashflows into and out of the fund, deal size and structure for all transactions, and annual marked-to-market valuation for each asset held in the fund. Statements should compare fund performance to performance of the pre-registered public benchmarks with equivalent cashflows and compare fee amounts collected to the self-capped total expense ratios. Reporting requirements implemented in the UK in 2019 are already producing in-depth third-party analyses and proposals for performance improvement.

State and local governments have ultimate responsibility for their pension systems, as do nonprofit trustees for their endowments. They will need to pursue reforms that incorporate available information, for instance limiting investment in high-fee funds to those that hold the fees in escrow and return them if the fund fails to outperform its benchmarks. They should also consider Canada's experience.

Canadian provinces have created government-owned agencies to manage numerous pension systems together, giving them the scale needed to employ appropriate expertise and access opportunities with lower fees. As New York University's Clive Lipshitz and Ingo Walter note, Canadian plans also tend to make direct investments in the real economy, rather than rely on external fund managers whose business strategies are not necessarily in the public interest and who extract a substantial share of investment returns as fees. Over the past ten years, Canadian pension investments have outperformed their American counterparts by approximately 200 basis points annually.

C. Reduce Financial Engineering.

Beneath the financial sector's misaligned risks and incentives lies the simpler problem of transactions that simply do nothing useful. Sometimes these maneuvers have tax or regulatory benefits; other times they win victories in a zero-sum game against less sophisticated counterparties. Smart people can generate tremendous profits this way, while creating no economic value and extracting capital out of the real economy.

Financial regulation must play a gatekeeping function, imposing judgment on what classes of activity even qualify as financial transactions that should have access to well-regulated public markets, the protection of the legal system, and so forth. Bets on sporting events, for instance, do not generally qualify. Insider trading is prohibited. Policymakers should:

1. Apply an economic activity test. Firms seeking to list their shares on a public exchange should be required to demonstrate in their filings that those shares represent an economic interest in a going business concern. This can include a holding company or index fund whose assets are themselves going concerns. It cannot include speculative mechanisms for placing leveraged bets or SPAC-like cash grabs for deployment at a later date. Firms that cease to be going concerns should be delisted.

2. Ban buybacks. American firms spend more than $1 trillion per year purchasing shares of their own stock. This phenomenon is not some inherent feature of a capitalist system, it is the direct result of a

decision by the Reagan Administration in 1982 to promulgate SEC Rule 10b-18, which gives a safe harbor from insider-trading and market-manipulation rules for such "buybacks." But of course, a firm deciding to buy its own shares on the open market is the very definition of insider trading. Unsurprisingly, insiders increase their volume of share sales five-fold around a repurchase announcement.

Buybacks are also a method of tax avoidance, deferring the tax payments that investors would owe if they received payouts in the more traditional form of dividends. As part of a tax reform that aims to shift the investment-tax incidence onto speculation and capital extraction, firms could be taxed on buybacks in the same way investors are taxed upon receipt of dividends. The simpler and better approach, though, is simply to return to the law as it stood before 1982 and ban buybacks entirely. Firms can return cash to shareholders via dividends whenever they want. If they truly feel too many shares of their stock are floating around the market, they can execute a reverse split that combines their shares into fewer, more valuable ones. They have no legitimate need to trade in their own stock.

3. Impose a financial transaction tax. The majority of transactions conducted today on public exchanges are the work of "high frequency traders" who buy and sell shares in a fraction of a second. They do this not for the purpose of actually supplying capital to real businesses, but rather to beat some other trader to the punch and thus claim a fraction of a penny in profit, or to implement an algorithm that predicts a trading profit if the exercise is repeated enough times. This serves no useful purpose but does manage to absorb a great deal of effort and talent, while transferring wealth from less sophisticated market participants.

A miniscule tax on each transaction—say, one-tenth of 1% of the transaction's value—would impose little to no net cost on actual investors while rendering infeasible the more absurd strategies of constant churning. Initial offerings that raise capital on behalf of operating companies should be excluded. Critics of such a tax warn that it would damage the financial market or chase investors abroad. This has not proved the case in either Hong Kong or London, both of which have remained dominant financial centers while maintaining financial transaction taxes.

Even the smallest of transaction taxes might raise tens of billions of dollars in revenue annually. When combined with the taxation of interest described above, the resulting revenue would be sufficient to fund other priorities that would greatly enhance the competitiveness of the U.S. economy generally and encourage higher levels of actual investment. These could include lowering the tax rate on the longest-term capital gains, making permanent the immediate expensing of capital investments, or providing the equity for a national infrastructure bank that could unlock trillions of dollars in private investment for vital national priorities. For an in-depth discussion of the transaction tax debate and fiscal policy options, see Chris Griswold's "No Need to Speculate: The Empirical Case for a Financial Transaction Tax."

While not the focus of this paper, a fourth area of reform bears mention in this same context: competition policy. Dysfunction in financial markets

causes all manner of harm in the real economy through misallocation of capital, talent, and risk, but problems flow in the other direction, too. The extraordinary rents anticipated from securing a natural monopoly in the technology sector inspire the venture capital industry's excessive focus on those types of businesses. Much of PE strategy comes down to identifying businesses that have large "moats" and might be able to raise prices substantially, or industries in which a "roll up" of numerous smaller businesses could create a dominant one. Reforms to discourage attainment of market power as the most attractive profit-seeking strategy in the real economy would encourage a more productive focus on actual investment in the financial sector.

Conclusion

Reformers go astray when their efforts transform into crusades and morality plays. Risk-taking, the pursuit of profit, even financial engineering—all are facts of life and, for that matter, valuable features of a well-functioning capitalist system. Effectively confronting Coin-Flip Capitalism should be an incremental process that starts from an understanding of why markets are malfunctioning and concludes not by wrecking them but by crafting rules under which they will work better. This will be unpopular with the people profiting most in today's finance sector, but fans of healthy financial markets may find much to like. As Adam Smith knew, those two groups are often at odds. ■

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