Clayton Christensen comes to Wall Street

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Chris Brummer, *Disruptive Innovation and Securities Regulation*, 84 **Fordham L. Rev.** -- (forthcoming, 2015), available at SSRN.

In the early 2000s, I spent some time as a fly on the wall of the floor of the New York Stock Exchange. I talked to specialists—those whose job it was to personally manage trading and make a market for particular high volume stocks—including one who had just earned a coveted specialist's "seat" (price: $3 million). Once upon a time, a seat was practically a license to make money. As market-makers, specialists bought low and sold high on their own accounts. The NYSE specialists I spoke to talked about decimalization, new at the time—the fact that securities were now quoted in pennies instead of in eighths or sixteenths of a dollar. They agreed that it had cut into their profitability. They were already using an electronic system to pair off small customer orders, and they agreed that it actually handled more order volume than they did. None of them seemed to have given much thought to electronic trading, alternative trading platforms, or the derivatives market. Certainly none of them seemed to think these were existential issues that would undermine their 130-year-old business model.

Securities markets are utterly transformed today. Specialists, as they were then, are gone. Electronic trading networks reign, as does algorithmic trading. The NYSE handles less than 20% of US stock trades (it was 80% just a decade ago). Chris Brummer's new article, *Disruptive Innovation and Securities Regulation,* is a gorgeous account of how this happened, how law intersected with innovation, and what the implications might be.

We know already that derivatives and financial engineering have profoundly challenged the assumptions underlying corporate law: think of Bernie Black and Henry Hu's work on empty voting,[1] Ron Gilson's and Chuck Whitehead's work on risk-slicing beyond the corporate share,[2] or Tamar Frankel's ruminations on how profoundly new technology affects Adolf Berle's classic analysis of the separation between ownership and control.[3] Bill Bratton and Adam Levitin have pointed out how innovations like the synthetic CDO involving a special purpose entity have redrawn the conceptual boundaries of a firm, and done through contract what formerly would have been done through equity ownership.[4] For a broader audience, Michael Lewis's influential book *Flash Boys* gave many a sense of the complex ecosystem in which high frequency traders operate (along with a sense of outrage about the disadvantage at which retail investors and even their pension and mutual funds are put in those ecosystems).

Chris Brummer's important contribution here is at least four-fold: first, he illuminates the historical dance, from the New Deal era onward, between securities regulation and financial sector innovation. The history he provides is engaging and precise, and he consolidates in one place information about how particular regulatory moves, like the SEC's Rule 144A (in 1994) or Regulation NMS (in 2007), unexpectedly rearranged markets and altered the business models of the very intermediaries—exchanges, broker-dealers and the like—they were intending to regulate. Among other unexpected relationships, he points out how greater *clarity* around the standards for private placements produced greater *innovation* around private placements. The relationship between clarity or standardization, and innovation, is an important one that does not always make it into conversations about finance or the financial crisis.

Second, Brummer identifies the ways in which new technology (particularly automated financial services and private capital markets, including dark pools and crowd-funding) has disrupted regulatory practice. For example, the SEC promulgated Regulation NMS in order to deal with the market fragmentation problem that electronic trading networks had created. It promulgated Rule 144A to help investors gain access to young, innovative, capital-intensive firms. The combined result, though, was to spur high frequency trading and to move trading off public markets, to the detriment of price discovery and fair treatment for retail investors (not to mention the specialists I once spoke to).

The other thing that comes out is how vast and tricky remains the challenge of consumer protection in this space. Consumer protection regulators like the SEC, and the law-based nature of their expertise, did not come out well during the financial crisis. In the wake of the crisis, policy-making momentum and credibility has shifted toward prudential regulation, and more technical financial expertise. Among the contributions in Brummer's article is a reminder that *someone* needs to be thinking hard about consumer protection, and priorities such as creating an equal playing field for "real economy" and retail players, in the midst of all this disruptive innovation.

Brummer's most significant contribution, though, is to pursue a conversation about how we might respond to the challenges that innovation presents for regulation. Back in 2009, Mitu Gulati and Bob Scott asked why law firms don't have R&D departments.[5] This is a good question (and they provide a fascinating answer) but the question goes beyond just firms. The reality is that law is not terribly good at tracking, let alone engaging in, innovation. This is true even for securities regulation, the area of law perhaps most directly concerned with allocating capital to its best (which often means its most innovative) uses. Brummer's article has done us a real service by setting out a thorough, insightful description of how far reality has strayed from the static, institution-oriented market structure that New Deal-era regulation assumes. His helpful proposals are to expand the regulatory perimeter, to consider the benefits and limits of objectives-based regulation, and to consider "adaptive financial regulation." We could perhaps even go further, to consider the ways in which financial regulation needs to be reframed to allow us to think about *innovation as a first order regulatory challenge.* How might our perspective change, if we started from the point to which Brummer brings us: from a sense of the historical dance between regulation and innovation, and a recognition of the ways in which regulation itself must anticipate and respond to the disruptive and undermining effects of private sector innovation?

1. Henry Hu and Bernie Black, Empty Voting and Hidden (Morphable) Ownership, **Business Lawyer,** 2006 at 1011. [2]

2. Ronald J. Gilson and Charles K. Whitehead, Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets, 108 **Colum. L. Rev.** 231 (2008). [?]
3. Tamar Frankel, The New Financial Assets: Separating Ownership from Control, 33 **Seattle U. L. Rev.** 931 (2010). [?]
4. William W. Bratton and Adam J. Levitin, A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs, 86 **S. Cal. L. Rev.** 783 (2013). [?]
5. Mit Gulati and Robert E Scott, The Three and a Half Minute Transaction: Boilerplate and the Limits of Contract Design, 40 **Hofstra L. Rev.** 1 (2012). [?]

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