

# THE FINANCIAL SECTOR UPHEAVAL OF 2008: SOCIOLOGICAL ANTECEDENTS AND THEIR IMPLICATIONS FOR INVESTMENT COMPANY REGULATION

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## I. INTRODUCTION

When Americans attempt to account for unwanted large-scale events, they normally focus on the actions of particular individuals. Perhaps because the culture of the United States has traditionally de-emphasized the group and favored the individual,<sup>1</sup> conditions and processes in society itself usually escape attention as the source of problems that are broad in scope and intense in magnitude. The inclination of Americans to blame specific people for an adverse societal event, however, ignores an important sociological proposition—that individuals, as members of a society, live in a *social system*, and that a society, being a system, is more than the sum of the individuals in it. Because a society is a system composed of general patterns of social conduct—i.e., because a society is an organized arrangement of recurring interpersonal activities—massive happenings and continuing

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In addition, I want to express my appreciation to three faculty members at the Widener University School of Law for their comments regarding this article: Lawrence A. Hamermesh, director of the Institute of Delaware Corporate and Business Law; Michael J. Slinger, director of the Legal Information Center; and Jules Epstein. Any errors in the article are, of course, solely my responsibility.

1. Michael Dominic Meuti, *Legalistic Individualism: An Alternative Analysis of Kagan's Adversarial Legalism*, 27 HASTINGS INT'L & COMP. L. REV. 319, 335 (2004).

behaviors that are serious problems for a society are unlikely to be due to action or inaction by identifiable individuals.<sup>2</sup> Rather, a major, harmful occurrence in a society tends to be an outcome of circumstances in the society per se.

To use sociological terminology, a society is a set of institutions, i.e., patterns of interpersonal behavior that are central to the continuation of the society.<sup>3</sup> Being components of a system, the institutions of a society are linked. Moreover, the interpersonal activities that are the building blocks for the institutions of a society involve, and are affected by, feedback loops that can create unanticipated difficulties and that can unexpectedly magnify the severity of difficulties, both those foreseen and those unforeseen. Important social problems, in short, manifest conditions and processes embedded in the society in which the problems occur, and when explaining the origin of such problems, Americans need to recognize that “we have met the enemy, and not only may he be ours, he may be us.”<sup>4</sup>

Regrettably, the preceding sociological propositions are typically not considered by law school faculty members, but the propositions are important because inter alia they lead to an awareness that a society can respond to attempted interventions, including interventions by the institution of law, in unwanted ways and with unwanted consequences. Indeed, the systemic character of a society may be responsible for frequent deviations from what was envisioned and desired by the members of the society and its institutions. The sociological propositions that are the focus of the instant article, accordingly, can aid in understanding the role of law in society.

Given that the systemic nature of social life is customarily overlooked in efforts to identify the causes of problems, an editorial published in September 2008 in a United States newspaper was unusual in explicitly placing responsibility for the upheaval then occurring in U.S. financial markets not on a numerically small group of market professionals but, instead, on Americans generally. “Greed,” the editorial explained, “has permeated every level of American society, from the Wall Street bankers and brokers to the middle-class homeowner.”<sup>5</sup> Of course, if the upheaval in finance in 2008 had its genesis in the very fabric of the social system rather than in a particular occupation or set of individuals, the operation of the finance sec-

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2. Larry D. Barnett, *The Roots of Law*, 15 AM. U. J. GENDER SOC. POL’Y & L. 613, 615, 673-74 (2007) [hereinafter *The Roots of Law*].

3. An institution is “an established . . . custom, usage, practice . . . or other element in the political or social life of a people; a regulative principle or convention subservient to the needs of an organized community or the general ends of civilization.” OXFORD ENGLISH DICTIONARY 1047 (2nd ed. 1989).

4. Walt Kelly, quoted in The Quotations Page, Rand Lindsly’s Quotations, <http://www.quotationspage.com/quote/22720.html> (last visited Oct. 13, 2008).

5. Editorial, *We All Have a Role in the Financial Failures of U.S.*, GREELEY TRIBUNE (COLO.), Sept. 28, 2008, available at LexisNexis ALLNWS library. See generally Evan Cornog, Commentary, NEWHOUSE NEWS SERVICE, May 26, 2006 (noting the prevalence and acceptance of selfishness in the United States), available at LexisNexis ALLNWS library.

tor involves matters that are not solely economic. Indeed, this contention is a centerpiece of the instant article. Specifically, I will argue that a key cause of, as well as a key process in, the upheaval were sociological.

Because the concepts and doctrines of the institution of law are products of the society in which they are found,<sup>6</sup> the 2008 disruption of U.S. financial markets can be expected to have ramifications for law. The disruption—which has been described as a “meltdown,”<sup>7</sup> “emergency,”<sup>8</sup> and “crisis”<sup>9</sup> in finance—has had global repercussions,<sup>10</sup> and the finance sector in the United States is likely to be changed by it. Indeed, the finance sector may undergo a restructuring to a degree that is sweeping in scope and historic in significance.<sup>11</sup> If such a restructuring takes place, it will alter U.S. law. Under my premise that sociological factors were central to creating the 2008 disruption, these factors must be included in explaining the change in law that results from the disruption.

Before we turn to the key events that marked the 2008 upheaval in financial markets, a point to keep in mind is that, although scholarship by law school faculty members has not come to terms with the sociological nature of the institution of law, that scholarship bears a special responsibil-

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6. Quantitative social science studies supporting this proposition are reviewed in Larry D. Barnett, *Mutual Funds, Hedge Funds, and the Public-Private Dichotomy in a Macrosociological Framework for Law* 11-13 (Univ. of Messina Interuniversity Centre for Research on Sociol. of Law, Info. and Legal Institutions, Working Paper No. 34, 2008), available at <http://www.cirsdig.it/indexeng.html> [hereinafter *The Public-Private Dichotomy*]. The proposition is discussed further in *The Roots of Law*, *supra* note 2, at 615, 636-37, 672-74.

The proposition that the content of law is determined by societal conditions rather than particular individuals seems not to be widely accepted, but its corollary is apparently resisted even more. The corollary is that regulatory law (i.e., law that is designed to regulate) does not directly shape patterns of social activity in a society to an appreciable degree and for an appreciable length of time. Social problems, therefore, are largely unresponsive to attempts by the institution of law to eliminate them or reduce their extent. For citations to quantitative social science research that finds law is relatively ineffective in changing social patterns, see Larry D. Barnett, *Law as Symbol: Appearances in the Regulation of Investment Advisers and Attorneys*, 55 CLEV. ST. L. REV. 289, 300-01 nn.65-67 (2007); Larry D. Barnett, *The Regulation of Mutual Fund Boards of Directors: Financial Protection or Social Productivity?*, 16 J.L. & POL'Y 489, 528-531 nn. 163-66 & 168, 545-46 (2008) [hereinafter *Regulation of Mutual Fund Boards*].

Even though regulatory law does not control social behavior, its societal role is important. By manifesting societal conditions and evolving in response to change in these conditions, regulatory law contributes to the cohesiveness of the social system even though it does not directly alter targeted social patterns. Specifically, law strengthens societal cohesiveness, and thereby assists in the operation of society, by furnishing symbols, (re)building interpersonal and intergroup trust, and (re)establishing the reputation of important societal segments. *Regulation of Mutual Fund Boards*, *supra* at 534-37, 545-46; Larry D. Barnett, *Social Productivity, Law, and the Regulation of Conflicts of Interest in the Investment Industry*, 3 CARDOZO PUB. L., POL'Y, & ETHICS J. 793 (2006).

7. E.g., Byron Acohido, *Tech Firms' Outlook Less Rosy; Near-term Forecasts Could Be Pared Back*, USA TODAY, Oct. 10, 2008, at 9A.

8. E.g., Sam Zuckerman, *Bailout Plan Back on Track in Congress, Pelosi Says*, S.F. CHRON., Sept. 27, 2008, at A1.

9. E.g., Sebastian Mallaby, *Main Street's Rescue*, WASH. POST, Oct. 10, 2008, at A19.

10. Steve Maich et al., *Edge of Disaster*, MACLEAN'S, Sept. 29, 2008, at 44.

11. Pete Engardio, *Forget Adam Smith. Whatever Works*, BUS. WK., Oct. 27, 2008, at 22.

ity to do so. Scholarship in the discipline of law is employed by courts in writing opinions,<sup>12</sup> and it may also be used in the future by administrative agencies and legislatures. Because publications by scholars in the field of law have practical applications, the publications should contribute to understanding *all* of the causes of a phenomenon that implicates law. The articles and books written by scholars in law on the financial market upheaval of 2008 thus need to examine the contribution of social forces and processes to the upheaval. If these publications do not do so, their utility will be unnecessarily diminished.

## II. THE FINANCIAL MARKET UPHEAVAL OF 2008

The upheaval that occurred in the finance sector in 2008 involved a severe contraction in the availability of credit, a marked reduction in the price of common stocks,<sup>13</sup> and an appreciable increase in interest rates on debt instruments issued by business entities and by state and local governments.<sup>14</sup> The immediate antecedent of the upheaval, according to a number of observers, was a rapid and substantial decline in the market value of owned homes in the United States.<sup>15</sup> The home-price decline produced the upheaval as that decline and a material increase in residential foreclosures reinforced each other.<sup>16</sup> However, the home-price decline was able to trig-

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12. Dennis Archer, *The Importance of Law Reviews to the Judiciary and the Bar*, 1991 DET. C.L. REV. 229.

13. From January 1, 2008 through December 31, 2008, the total investment return of the S&P 500 stock index was -37.0 percent. Total investment return is computed from both change in the price of a share of stock and payment of cash dividends per share. STANDARD & POOR'S, S&P 500, [http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices\\_500/2,3,2,2,11,31,2008,0,0,0,0,0,0,0,0,0,0.html](http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_500/2,3,2,2,11,31,2008,0,0,0,0,0,0,0,0,0,0.html) (last visited Jan. 1, 2009). The calendar-year price decline of the S&P 500 was larger in 2008 than in any calendar year since 1937. Elizabeth Stanton, *U.S. Stocks Post Steepest Yearly Decline Since Great Depression* (Jan. 1, 2009), <http://www.bloomberg.com/apps/news?pid=20601084&sid=a5RkfQG30k1k&refer=stocks>.

14. Jeremy R. Cook & Michael McDonald, *Muni Sales Dry Up as States Face \$42 Billion Deficit* (Update 1), BLOOMBERG, Dec. 31, 2008, [http://www.bloomberg.com/apps/news?pid=20601015&sid=aE\\_Syu\\_H1HRM&refer=munibonds](http://www.bloomberg.com/apps/news?pid=20601015&sid=aE_Syu_H1HRM&refer=munibonds); Gabrielle Coppola & Bryan Keogh, *Company Bond Sales Fall as Recession Drives Rates Up* (Update 2), BLOOMBERG, Dec. 31, 2008, <http://www.bloomberg.com/apps/news?pid=20601009&sid=a2Czskdlu1EY&refer=bond>

15. Vikas Bajaj & Louise Story, *Mortgage Crisis Spreads Past Subprime Loans*, N.Y. TIMES, Feb. 12, 2008, at A1; Engardio, *supra* note 11, at 23; Russell Grantham, *Financial Shake-Up: Collapses Create Nervous Consumers, Risking a Deep Depression*, ATLANTA J.-CONST., Sept. 21, 2008, at 1B. The Secretary of the U.S. Department of the Treasury has stated that "[t]he U.S. housing correction was clearly the spark that ignited the financial crisis." Henry M. Paulson, Jr., Remarks at the Ronald Reagan Presidential Library (Nov. 20, 2008), <http://www.treas.gov/press/releases/hp1285.htm>.

16. *A Helping Hand to Homeowners*, ECONOMIST, Oct. 25, 2008, at 92; Maich et al., *supra* note 10; Steve Maich, *Facts and Fairy Tales of Paulson's Bailout*, MACLEAN'S, Oct. 20, 2008, at 47. The proportion of mortgage loans that were in foreclosure started to rise in 2006, and the rise continued through the third quarter of 2008, the latest quarter for which data are available. *Is Housing Close to a Bottom?*, BUS. WK., Dec. 22, 2008, at 11. From the second quarter of 2006 to the third quarter of 2008, the proportion increased from less than 2 percent to more than 5 percent. *Id.*

ger the upheaval only because homeownership is widespread in the United States. The popularity of homeownership, in turn, is partially a function of social values,<sup>17</sup> a factor evidencing the systemic character of society.

Although home prices started to fall in 2006, the decline was gradual until the last half of 2007. The S&P/Case-Shiller National Home Price Index,<sup>18</sup> which covers single-family homes in the United States as a whole and is computed for each calendar quarter at the end of the quarter,<sup>19</sup> was 90 percent higher in the second quarter of 2006 than it had been in January 2000, the base period.<sup>20</sup> Between the second quarter of 2006 and the third quarter of 2007, however, the Index fell almost ten percentage points, and during each of the next two quarters, it declined at an even faster quarterly pace—roughly ten percentage points in the fourth quarter of 2007 and about eleven percentage points in the first quarter of 2008. Further (though smaller) quarterly declines were experienced in the second and third quarters of 2008. The result was that the Index was approximately forty percentage points lower in the third quarter of 2008 (the latest quarter for which data are available) than at its peak in the second quarter of 2006.

If the decrease in the market price of owned homes in the United States triggered the financial crisis of 2008, an explanation is needed of why it did so. In a system, an immediate antecedent does not activate a major occurrence by itself. Rather, a change in a society brings about a large-scale effect because of certain conditions in the society, and although identifying all of these conditions is not a simple task, they must be uncovered to understand the effect being investigated—here, the upheaval in finance that occurred in 2008.

In order to locate the range of antecedents of the upheaval in finance, we must ascertain the principal factors that formed the economic context of the home-price decline. These factors, while more-distant antecedents of the upheaval, are important because they were links in the chain of causation. When considering economic factors, however, we must not neglect

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17. Richard Harris & Chris Hamnett, *The Myth of the Promised Land: The Social Diffusion of Home Ownership in Britain and North America*, 77 ANNALS ASS'N AM. GEOGRAPHERS 173, 174-75 (1987).

18. S&P/Case-Shiller Home Price Indices, *S&P/Case-Shiller U.S. National Home Price Index* (Excel spreadsheet) (Nov. 25, 2008), [http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices\\_csmahp/0,0,0,0,0,0,0,0,0,0,2,1,0,0,0,0,0.html](http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,0,2,1,0,0,0,0,0.html). The Index is widely accepted as a measure of home prices. Kimberly Blanton, *Boston House Prices Show Some Spring*, BOSTON GLOBE, July 30, 2008, at C1; David Leonhardt & Vikas Bajaj, *Drop Foreseen in Median Price of Homes in U.S.*, N.Y. TIMES, Aug. 26, 2007, at A1.

19. STANDARD & POOR'S, S&P/CASE-SHILLER HOME PRICE INDICES: INDEX METHODOLOGY 27 (2008), [http://www2.standardandpoors.com/spf/pdf/index/SP\\_CS\\_Home\\_Price\\_Indices\\_Methodology\\_Web.pdf](http://www2.standardandpoors.com/spf/pdf/index/SP_CS_Home_Price_Indices_Methodology_Web.pdf). The Index uses the selling price of each structurally unchanged single-family home in the United States that is sold in a transaction in which the selling price is determined by bargaining; the Index is constructed from all such transactions. *Id.* at 16-18.

20. *Id.* at 14, 33. While the Index employs a single month for the base period, it uses three months for measuring change from the base period. *Id.* at 6.

the social conditions that lay behind them, in part because social conditions have a major bearing on whether and how government regulates finance. Social conditions can lead to (or prevent) a financial problem in a society, because they involve inter alia a set of assumptions regarding the prerequisites for a maximally effective economy. The assumptions shape the nature and extent of regulation of the economy,<sup>21</sup> and when a particular set of assumptions is displaced by a different set—which involves change in the social character of a society—one historical era ends and another starts. In the final analysis, then, the structure and regulation of finance result from a set of ideas that has been accepted by society.<sup>22</sup>

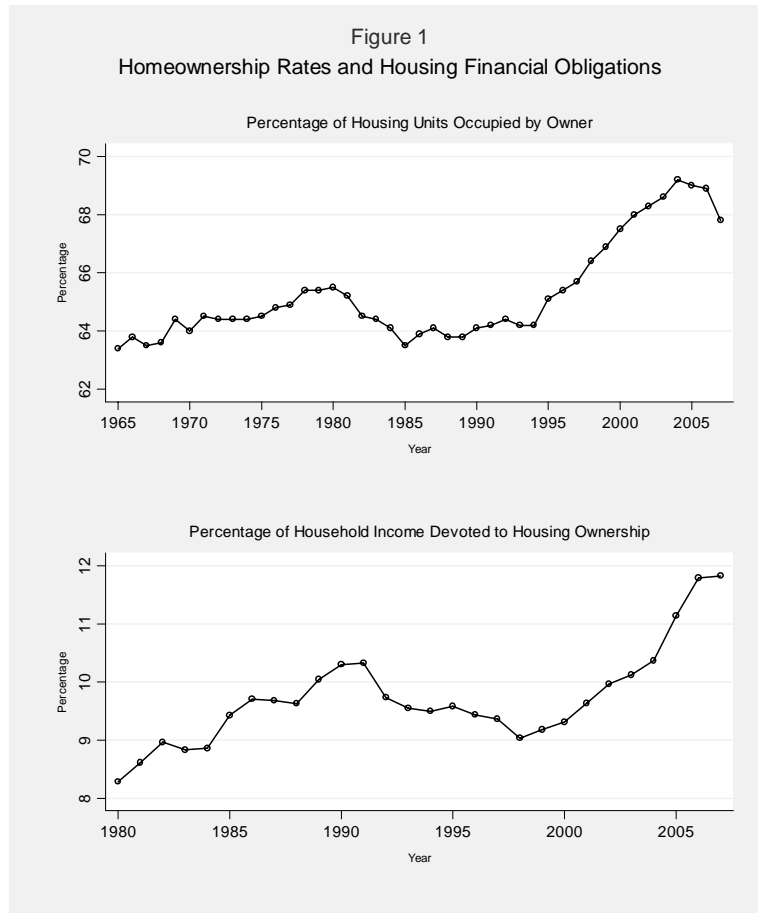
Two related economic factors, acting in combination, were apparently central forerunners of the home-price decline that became the immediate antecedent of the 2008 upheaval in finance.<sup>23</sup> As will be evident below, the factors did not materialize suddenly; instead, they developed over an extended time span. The factors are shown in the vertically arranged graphs comprising Figure 1. Each graph covers a period that ends in 2007 and uses data on the United States for the fourth quarter of every calendar year included in its time series.

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21. CHARLES R. MORRIS, *THE TRILLION DOLLAR MELTDOWN* 27, 34-35, 54 (2008). The principle in the text is illustrated by testimony to a committee of the House of Representatives in October 2008 by Alan Greenspan, who answered affirmatively and unequivocally when asked whether the economic philosophy he followed as chair of the Federal Reserve Board of Governors had one or more erroneous assumptions. Edmund Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 23, 2008, [http://www.nytimes.com/2008/10/24/business/economy/24panel.html?\\_r=1&hp&oref=slogin](http://www.nytimes.com/2008/10/24/business/economy/24panel.html?_r=1&hp&oref=slogin). Mr. Greenspan chaired the Board of Governors of the U.S. Federal Reserve System from 1987 to 2006.

22. Cf. MICHAEL J. SANDEL, *DEMOCRACY'S DISCONTENT* 224-27 (1996) (attributing to social ideology the manner in which government regulates the economy through law and policy).

23. The discussion here is intended to be no more than suggestive. Quantitative research will be necessary to uncover all of the economic factors that were important contributors to the upheaval, to ascertain the sequence in which the factors operated, to determine the direct and indirect effects of each factor, and to identify the nature and magnitude of these effects.



One of the factors responsible for making the home-price decline the immediate antecedent of the 2008 upheaval in finance was the percentage of all housing units in the United States that were occupied by their owners.<sup>24</sup> Yearly data on this percentage are available from 1965 onward<sup>25</sup> and

24. The numerator for the proportion is the number of housing units in the United States that were occupied by their owners. Housing units are classified as "owner-occupied" if the owner-occupants regard the units as their usual place of residence whether or not the owner-occupants purchased their units with loans that have yet to be fully repaid; thus, a housing unit is considered to be occupied by its owner even when the owner-occupant is a mortgagor. Homeownership rates are based on the civilian non-institutionalized population, which includes inter alia civilians who are in households, military personnel who are in households that reside off a military post, and military personnel who are in households that reside on a military post and contain a family member who is a civilian adult. U.S. CENSUS BUREAU, DIFFERENCES BETWEEN THE *HOMEOWNERSHIP RATE* ESTIMATES FROM THE AMERICAN COMMUNITY SURVEY, THE CURRENT POPULATION SURVEY/HOUSING VACANCY SURVEY, AND THE AMERICAN HOUSING SURVEY (Nov. 30, 2004), <http://www.census.gov/hhes/www/housing/homeown->

appear in the upper graph in Figure 1. An unmistakable, rapid rise in the percentage begins in the mid-1990s, with owner-occupied housing units as a share of all housing units increasing from 64.2 percent in 1994 to 69.0 percent in 2005.<sup>26</sup> The increase has been attributed in large part to the concurrent expansion of lending to “subprime” borrowers, i.e., borrowers who are unable to obtain a loan with a relatively low interest rate because they have been classified as having a high likelihood of defaulting on their financial commitments.<sup>27</sup> In addition, the decline of interest rates during the same period has been viewed as a factor that encouraged the ownership of housing, and the acquisition of more expensive housing, than would have been acceptable under conventional criteria.<sup>28</sup>

The second factor that made the home-price decline the immediate antecedent of the upheaval in finance was the pressure placed on household income from the financial obligations associated with ownership of a home. The bottom graph in Figure 1 presents, for the period from 1980 to 2007, the estimated percentage of the total disposable personal income of household members that was devoted each year to payments on mortgages and to payments for mortgage-related expenses, viz., homeowners’ insurance and property taxes.<sup>29</sup> A substantial rise in the percentage is evident starting in the last half of the 1990s. To be exact, the portion of household income allocated to mortgages and related expenses went from 9.04 percent in 1998 to 11.83 percent in 2007.<sup>30</sup>

The decline that began in 2006 in the market price of homes, then, occurred after the segment of the population experiencing financial pressure from homeownership had appreciably expanded in size. The increases

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ership factsheet.html.

25. The data are from U.S. CENSUS BUREAU, TABLE 14: HOMEOWNERSHIP RATES FOR THE U.S. AND REGIONS: 1965 TO PRESENT, <http://www.census.gov/hhes/www/housing/hvs/historic/index.html>.

26. *Id.* The total number of housing units in the United States was also growing at this time, but the pace of the growth did not deviate markedly from the pace in earlier years. See U.S. Census Bureau, *Table 7: Estimates of the Housing Inventory for the United States: 1965 to Present*, <http://www.census.gov/hhes/www/housing/hvs/historic/index.html>.

27. A. Brooke Overby, *Mortgage Foreclosure in Post-Katrina New Orleans*, 48 B.C. L. REV. 851, 898-99 (2007); Richard A. Brown & Susan E. Burhouse, *Implications of the Supply-Side Revolution in Consumer Lending*, 24 ST. LOUIS U. PUB. L. REV. 363, 369-70 (2005).

28. Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NW. U. L. REV. 1463, 1499-1500 (2005). The decline in interest rates for housing loans in the United States as a whole is illustrated by the mean interest rate on a 30-year fixed-rate mortgage loan at the time the lender committed to making the loan. The rate decreased from a yearly average of 8.38 percent in 1994 to 5.87 percent in 2005. FREDDIE MAC [FED. HOME LOAN MORTGAGE CORP.], MONTHLY AVERAGE COMMITMENT RATE AND POINTS ON 30-YEAR FIXED-RATE MORTGAGES SINCE 1971, <http://www.freddiemac.com/pmms/pmms30.htm>. The yearly average was 6.41 percent in 2006 and 6.34 percent in 2007. *Id.*

29. FEDERAL RESERVE BOARD, HOUSEHOLD DEBT SERVICE AND FINANCIAL OBLIGATIONS RATIOS (Sept. 22, 2008), <https://www.federalreserve.gov/releases/housedebt/default.htm>. The graph uses data for the fourth quarter of each year.

30. *Id.*

that had occurred since the mid-1990s in the prevalence of homeownership were accompanied by growth in the share of household income devoted to homeownership expenses. The home-price decline was thus tied to other changes that had taken place in U.S. society, and as residential foreclosures accompanied the decline and became more common, the financial sector was severely disrupted.

### III. SOCIOLOGICAL CONCEPTS AND FINANCIAL MARKET EXIGENCIES

Sociology is a discipline with many specialties and numerous concepts, and it can contribute to understanding exigencies in finance. Two of the concepts traditionally used in sociology<sup>31</sup> seem especially promising as avenues to understanding the upheaval in finance that occurred in 2008. These are the concepts of *social values* and *collective behavior*. Social values are believed to explain, or at least describe, differences between societies at any one point in time<sup>32</sup> and changes within a particular society over time.<sup>33</sup> Collective behavior is considered to be a salient and not-uncommon aspect of social life. The two concepts, accordingly, have become central to the sociological enterprise.

Before the concepts of social values and collective behavior can be discussed, however, each must be defined. In the instant article, social values will refer to the ideals that are accepted by the members of a society and that influence the conduct of the members in a variety of situations and over an extended period of time.<sup>34</sup> Values are thus conceptions of the aims of social life that are broad in scope and enduring in duration.

Collective behavior, on the other hand, cannot be readily defined. Sociologists seem not to have agreed on its key elements<sup>35</sup> even though they uniformly accept that certain types of phenomena—e.g., crowds, panics, and riots—involve collective behavior.<sup>36</sup> Declines in securities prices that are large and rapid, including those experienced in 2008, involve col-

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31. Steven Hitlin & Jayne Allyn Piliavin, *Values: Reviving a Dormant Concept*, 30 ANN. REV. SOCIOL. 359, 359 (Karen S. Cook & John Hagan eds., 2004); Benigno E. Aguirre & E. L. Quarantelli, *Methodological, Ideological, and Conceptual-Theoretical Criticisms of the Field of Collective Behavior: A Critical Evaluation and Implications for Future Study*, 16 SOCIOL. FOCUS 195, 195 (1983).

32. Shalom H. Schwartz, *A Theory of Cultural Values and Some Implications for Work*, 48 APPLIED PSYCHOL. 23, 32-40 (1999).

33. Ronald Inglehart & Wayne E. Baker, *Modernization, Cultural Change, and the Persistence of Traditional Values*, 65 AM. SOCIOL. REV. 19, 49 (2000).

34. Hitlin & Piliavin, *supra* note 31, at 361-62.

35. Clark McPhail, *The Crowd and Collective Behavior: Bringing Symbolic Interaction Back In*, 29 SYMBOLIC INTERACTION 433, 455 (2006).

36. Hank Johnston & Shoon Lio, *Collective Behavior and Social Movements in the Postmodern Age: Looking Backward to Look Forward*, 41 SOCIOL. PERSPECTIVES 453, 454-55 (1998).

lective behavior because panic occurs during the declines and, indeed, is a factor contributing to them.<sup>37</sup> While the central dimensions of collective behavior have yet to be identified by the professionals who study the phenomenon,<sup>38</sup> I will employ the concept of collective behavior to refer to conduct that involves numerous individuals, that has a shared objective or purpose, and that occurs during the same period of time. The conduct of individuals that comprises collective behavior, however, is not merely the sum of the conduct of each individual; the behavior is *collective* because the conduct of each participant affects, and is affected by, the conduct of other participants. The conduct of participants in collective behavior, moreover, exhibits some degree of spontaneity (popularly known as “emotion”); the participants in an instance of collective behavior may not have a single set of leaders; and a large proportion of the participants may not interact face-to-face or intend to exchange communications. Collective behavior can involve individuals who are strangers if the conduct of some of them prompts and/or reinforces the conduct of others.

Unfortunately, the sociological specialty of collective behavior seems not to have developed a cohesive body of knowledge that includes relatively precise estimates of the magnitude of relationships between pertinent variables and that is derived from a substantial number of empirical (let alone quantitative) studies. The situation may be due to the serious impediments confronting research on collective behavior,<sup>39</sup> but whatever the reason(s), the situation is likely to account, at least in part, for the present inability of sociologists to agree on a definition of collective behavior as a phenomenon. Simply put, useful knowledge regarding collective behavior is limited.<sup>40</sup> Accordingly, the instant article will not consider collective behavior further, but readers should be aware that sociologists will in time unearth important aspects of collective behavior that will shed light on events such as the 2008 upheaval in finance.<sup>41</sup>

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37. Brenda Spotton Visano, *Financial Manias and Panics*, 61 AM. J. ECON. & SOCIOL. 801 (2002).

38. The lack of agreement among sociologists on a definition of collective behavior may be due to the lack of a clear boundary between collective behavior and occurrences known as social movements. Sociologists have attempted to link research on collective behavior and research on social movements, but they have had limited success in doing so. Johnston & Lio, *supra* note 36, at 454. The difficulty of tying collective behavior and social movements may stem at least partly from the absence of an unambiguous line between the two phenomena.

39. Stephen Vider, *Rethinking Crowd Violence: Self-Categorization Theory and the Woodstock 1999 Riot*, 34 J. THEORY SOC. BEHAV. 141, 141-142 (2004), available at <http://search.EBSCOhost.com>.

40. Indeed, research on collective behavior has yet to answer basic questions about such behavior. David Schweingruber & Clark McPhail, *A Method for Systematically Observing and Recording Collective Action*, 27 SOCIOL. METHODS & RES. 451, 458-61 (1999).

41. Research on collective behavior in financial markets may find that the frequency and impact of such collective behavior has changed over the course of history. Such change may have occurred because, *inter alia*, of the development and adoption of new technologies, e.g., broadcasting, cell tele-

The remainder of the article will focus on social values, the change that the United States has experienced in specific social values during the last several decades, and one consequence of the change in values that is especially important for American society. In particular, I concentrate on social values characterizing the population of the United States with regard to hedonism, materialism, and time horizon—three dimensions that can be distinguished as concepts but that are probably correlated empirically.<sup>42</sup> In terms of hedonism, the question is the extent to which personal pleasure is emphasized and pursued in a society. In terms of materialism, the question is the extent to which goods and services classifiable as luxuries are sought in a society instead of intellectual and spiritual development. In terms of time horizon, the question is the extent to which short-term considerations or long-term considerations matter in a society. To illustrate time horizon, short-term considerations are manifested inter alia in the desire for rewards quickly (often labeled “immediate gratification”) rather than rewards later (“deferred gratification”). Social values that endorse hedonism, materialism, and a short-term orientation are relevant to the instant article because they and their impact on the intellectual skills of the U.S. population are likely antecedents of the financial sector upheaval of 2008.<sup>43</sup> As a result of these social values and the suboptimum analytical acumen to which they led, Americans invested and spent in ways and to an extent that were imprudent. A severe disruption in the operation of financial markets, with its large-scale effect on the economy, was the eventual outcome.

#### IV. CHANGE IN SOCIAL VALUES IN THE UNITED STATES

I now present quantitative data bearing on the extent of and change in social values regarding hedonism, materialism, and time horizon among Americans. The evidence considered as a whole supports the conclusion that hedonism, materialism, and short-term considerations have been appreciably more widespread among Americans in recent years than in the past, but the reader should be aware that the evidence is neither as complete

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phones, and email. Daniel J. Myers, *Racial Rioting in the 1960s: An Event History Analysis of Local Conditions*, 62 AM. SOCIOLOGICAL REV. 94, 97 (1997).

42. See Keith Hayward, *Situational Crime Prevention and its Discontents: Rational Choice Theory versus the ‘Culture of Now,’* 41 SOC. POL’Y & ADMIN. 232, 239–41 (2007) (describing general theoretical models that link hedonism, materialism, and a short-term time horizon in present-day societies); James E. Burroughs & Aric Rindfleisch, *Materialism and Well-Being: A Conflicting Values Perspective*, 29 J. CONSUMER RES. 348, 359, 365 (2002) (finding in a small sample that a high level of materialism in individuals tends to be accompanied by a high level of hedonism).

43. E.g., Victor Davis Hanson, *Why the U.S. Economy will Rebound Before Others*, SAN JOSE MERCURY NEWS (Cal.), Oct. 30, 2008 (contending that the 2008 upheaval in finance occurred because Americans were characterized by “greed [that] drove us to demand even more than we had earned” and because Americans were in “a hypnotic trance of self-indulgence”).

nor as exact as I would like. In particular, I was able to locate just two studies that have repeatedly drawn samples over time from the U.S. population and asked members of the samples to answer questions revealing the members' social values on hedonism, materialism, and/or time horizon. While neither of the two studies utilized a question that was facially valid<sup>44</sup> as well as pertinent,<sup>45</sup> each study asked a question that gauges indirectly at least one of the values. Data from both studies are reported below in part IV-A. To supplement the two studies, part IV-A also presents quantitative data that reveal change over time in several manifestations of the values of interest here. In part IV-B, I review data on the intellectual skills of the U.S. population and contend that these skills have been damaged by the shift that has occurred in social values on hedonism, materialism, and time horizon. Shifts in values are important not only in their own right but also for the societal problems they create.<sup>46</sup>

#### A. MEASURES OF SOCIAL VALUES

I begin with the two studies that asked respondents to answer a question concerned with the social values on which I am focusing. The first is the Monitoring the Future ("MTF") study, which began in 1975 and is a recurring, annual survey of a nationwide sample of students who are in their last year of high school prior to graduation, i.e., who are enrolled in their

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44. A facially valid question would attempt to tap these values with an explicit reference to the values. However, data produced by facially valid questions designed to measure social values can produce erroneous data to the extent that current values diverge from traditional values, because in answering questions, survey respondents tend to rely on the values endorsed by their cultural heritage. Matthew J. Streb et al., *Social Desirability Effects and Support for a Female American President*, 72 PUB. OPINION Q. 76, 78-80 (2008). Traditionally, hedonism and materialism have been disfavored by the religious faiths that dominate the United States. ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 514-16 (J. P. Mayer & Max Lerner eds., George Lawrence trans., Harper & Row 1966) (1840). Not surprisingly, therefore, an inverse relationship has been found among individuals between degree of religious commitment and strength of materialism. Wendy M. Rahn & John E. Transue, *Social Trust and Value Change: The Decline of Social Capital in American Youth, 1976-1995*, 19 POL. PSYCHOL. 545, 560 (1998). In light of the teachings of the main religions in the United States, a substantial number of Americans are likely to be unwilling to admit that they approve, or at least do not disapprove, of hedonism and materialism, and can be expected to misstate their personal view when responding to questions explicitly referencing these values. Data from facially valid questions thus probably understate the extent of hedonism and materialism.

45. One of the two studies asked whether respondents believed that "[p]eople are too much concerned with material things these days." JERALD G. BACHMAN ET AL., *MONITORING THE FUTURE: QUESTIONNAIRE RESPONSES FROM THE NATION'S HIGH SCHOOL SENIORS, 2006*, at 104 (item number 6000) (2008), <http://www.monitoringthefuture.org/pubs.html#refvols>. The question measures the respondents' evaluation of the degree to which materialism exists among other individuals or among individuals generally. Because the question does not measure the degree to which the respondents personally are materialistic, I concluded that it does not permit an accurate assessment of the extent of materialism in the United States. Accordingly, data from the question are not employed here.

46. Of course, social problems can be avoided by the content of and change in values, but that did not happen in the situation being examined in the instant article.

senior year of high school.<sup>47</sup> Every year the questionnaire for the MTF study has asked the respondents to “disagree,” “mostly disagree,” “mostly agree,” “agree,” or “neither” disagree nor agree with the statement that “To me, work is nothing more than making a living.”<sup>48</sup> Responses to the statement are presumed to measure the presence or absence of hedonism.

Figure 2 presents the yearly percentages of high school seniors who, in responding to the statement on whether “work is nothing more than making a living,” answered either “agree” or “mostly agree” and who, by doing so, portrayed themselves as hedonistic. The percentages are shown for each sex, because the indicators of hedonism—i.e., the responses “agree” and “mostly agree”—are found among females as a group noticeably less often than among males as a group. The Figure covers the entire period for which MTF data have been published, viz., 1975 through 2006.<sup>49</sup>

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47. BACHMAN ET AL., *supra* note 45, at 2-3, 9-10. The MTF study covers students in public high schools as well as students in private high schools. *Id.* at 2, 4.

48. This statement is numbered item 8060 in the MTF study, and given the wording of the statement, agreement with it is evidence of a hedonistic orientation. The questionnaire for the study contained a series of statements dealing with leisure and work, and item 8060 was the second in the series. (The alternatives available for responding to item 8060 were available for responding to every statement in the series.) Notably, item 8060 was preceded by the statement (item 8050) that “I like the kind of work you can forget about after the work day is over.” *Id.* at 18, 137, 320-21. Research on responses to questions in sample surveys has found that a prior item can affect responses to the item that follows. Alexander Todorov, *Context Effects in National Health Surveys: Effects of Preceding Questions on Reporting Serious Difficulty Seeing and Legal Blindness*, 64 PUB. OPINION Q. 65, 65, 73-74 (2000). The wording of item 8050 is likely to have increased the inclination of survey respondents to interpret item 8060 in terms of hedonism.

49. Except for 1989, the yearly data in the Figure are from the individual reference volumes of the MTF study. The volumes are listed at <http://www.monitoringthefuture.org/pubs.html#refvols>. The MTF volume for 1989 could not be obtained, and the data for that year, consequently, are from table 5 in John Schulenberg et al., *Monitoring the Future Occasional Paper No. 37, Historical Trends in Attitudes and Preferences Regarding Family, Work, and the Future Among American Adolescents: National Data from 1976 through 1992*, at 17 (Inst. for Soc. Research, Univ. of Michigan, 1994), <http://monitoringthefuture.org/pubs/occpapers/occ37.pdf>.

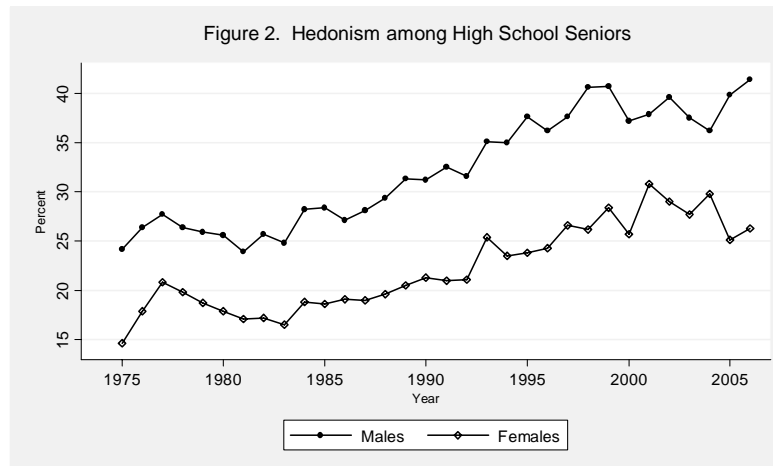


Figure 2 reveals secular change over time in the prevalence of hedonism among males and among females. Specifically, a steady and substantial rise in hedonism takes place from the first half of the 1980s to the last half of the 1990s, at which point the prevalence of hedonism reaches a plateau. The increase in hedonism, however, was somewhat larger among males than females, and as a result, the sex gap in this plateau is greater than the sex gap during the early part of the period covered by Figure 2. To illustrate, the gap in percentage points ranged from 8.5 to 9.6 in 1975-1976 and from 8.0 to 9.8 in 1985-1986. In 1995-1996, however, the gap in percentage points ranged from 11.9 to 13.8, and in 2005-2006, it ranged from 14.7 to 15.1.

The second study that probed pertinent social values through responses to a question asked of cross-sections of the U.S. population is the General Social Survey (“GSS”). The GSS has been conducted annually or biennially since 1972 and obtains data on a variety of characteristics of adults (i.e., persons 18 years of age and older) who reside in the United States, although interviewees were limited to English-speaking adults until 2006.<sup>50</sup> The GSS is relevant here because it has frequently included a question on the aspects of employment that respondents consider most important. Specifically, interviewees have been shown a card naming five aspects of employment and asked to designate “which one thing on this list you would most prefer in a job.” One of the aspects named was “high income.”<sup>51</sup> Income level, of course, affects the ability of the income recipi-

50. NAT’L OPINION RES. CENTER, GENERAL SOCIAL SURVEYS, 1972-2006 CUMULATIVE CODEBOOK vii (2008), <http://www.norc.org/GSS+Website/Codebook>. In 2006, adults who spoke only Spanish were interviewed along with adults who spoke English. *Id.*

51. The other four aspects were (i) “No danger of being fired,” (ii) “Workings [sic] hours are short, lots of free time,” (iii) “Chances for advancement,” and (iv) “Work important and gives a feeling of

ents to acquire consumable goods and services, and it can also be a determinant of whether the income recipients are able to engage in pleasurable activities beyond such acquisition. Responses to this question, accordingly, can be expected to reveal, albeit imperfectly, the prevalence of materialism and hedonism.<sup>52</sup> The question was asked in almost every year from 1973 through 1994 that the GSS was conducted, but after 1994, it was not asked again until 2006.<sup>53</sup>

Given the utility of the question and the lengthy time span for which data on it are available, I turn to the percentages of Whites<sup>54</sup> in each year who considered “high income” the most desirable feature of a job.<sup>55</sup> The data are for respondents of both sexes who were 20-29 years old.<sup>56</sup> Two reasons account for the age restriction. First, to the extent that the values of the age group 20-29 diverge from the values of older age groups and are largely unaffected by the aging process, the values of the population as a whole will, *ceteris paribus*, move gradually toward the values that were held by persons at age 20-29 because, with the passage of time, the members of the older cohorts die and are replaced by the members of the younger cohorts. Second, persons who were 20-29 years old in the 1970s are likely to have still been economically active during the years immediately preceding the financial sector upheaval of 2008. Indeed, during the decade prior to the upheaval, aging and cohort succession had probably placed members of this age group in influential positions in finance, and aging had evidently led a large proportion of them to become securities investors.<sup>57</sup> The social values of persons 20-29 years old thus offer useful evidence of the social values that led to the 2008 upheaval in finance.

What does the data reveal? Among Whites 20-29 years old, high income was ranked as the most important aspect of a job by 12.8 percent in 1973 and by 9.9 percent in 1974. In every subsequent year in which the

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accomplishment.” *Id.* at 271-72.

52. Income that is not required for minimum necessities may, of course, be spent for other than hedonistic or materialistic purposes. Given the culture of the United States, however, the assumption is likely to be correct that such income will be devoted to activities involving hedonism and materialism.

53. NAT’L OPINION RES. CENTER, *supra* note 50, at 2419.

54. The percentages for Nonwhites are not reported because of the small numbers of Nonwhites in the yearly samples.

55. The mnemonic label of the question was JOBINC. The percentages were obtained from the GSS 1972-2006 Cumulative Datafile, <http://sda.berkeley.edu/cgi-bin/hdsda?harcda+gss06>. All of the percentages were calculated using the WTSSALL weight. See NAT’L OPINION RES. CENTER, *supra* note 50, at 2108 (explaining the reason for weighting by the number of adults in the household of each interviewee).

56. The percentages are not presented separately for males and for females because doing so would require the use of unacceptably small numbers of respondents.

57. INVESTMENT COMPANY INSTITUTE, 2008 INVESTMENT COMPANY FACT BOOK 157 (48th ed. 2008) [hereinafter INVESTMENT COMPANY FACT BOOK], <http://www.ici.org/stats/mf/index.html#FactBook> (reporting that, in 2007, slightly more than half of U.S. households whose head was age 45-64 owned shares of a mutual fund).

question was asked, however, the percentages were materially larger, although quite variable. In 1976 and 1977, the percentages were 20.9 and 16.6, respectively, and during the 1980s, the percentages ranged from 16.2 to 35.1. From 1990 to 1994, the percentages were between 20.4 and 25.1, and in 2006, the last year the question was included in the GSS, 18.8 percent regarded high income as the most preferred aspect of a job. Although the post-1975 percentages cover a substantial range, the data for 1973-2006 as a whole suggest that, after the first half of the 1970s, hedonism and materialism became much more common in the United States and their prevalence remained elevated.

I turn now to another type of evidence. While social values are abstractions from human behavior, they are embodied in behavior. Behavioral patterns are observable, of course, and can be (and have been) measured. We can thus take advantage of quantitative data on behavioral patterns manifesting hedonism, materialism, and/or a short-term time horizon. These manifestations include the following:

- Obesity, which evidently becomes more probable with increases in physical inactivity and amount of food (especially fat) consumed,<sup>58</sup> grew steadily more common among adults 20-74 years old in the United States between 1960-1962 and 2003-2004.<sup>59</sup> Adjusting for change over time in the age distribution of persons 20-74 years old, obesity was two-and-a-half times more prevalent in 2003-2004 than it had been in 1960-1962.<sup>60</sup>
- The median number of square feet of floor area in new single-family houses that were sold in the United States fluctuated around 1,600 during the period 1978-1985 but rose to approximately 2,200 during the period 2004-2007.<sup>61</sup> Between the former period and the latter period, consequently, the median

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58. James O. Hill & John C. Peters, *Environmental Contributions to the Obesity Epidemic*, 280 SCI. 1371 (1998).

59. NAT'L CENTER FOR HEALTH STATISTICS, U.S. DEP'T OF HEALTH & HUM. SERVICES, PUBL'N NO. 2007-1232, HEALTH, UNITED STATES, 2007, at 104 (2007), <http://www.cdc.gov/nchs/data/hus/hus07.pdf>.

60. Calculated from *id.* at 104.

61. NAT'L ASS'N OF HOME BUILDERS, MEDIAN AND AVERAGE SQUARE FEET OF FLOOR AREA IN NEW ONE-FAMILY HOUSES SOLD BY LOCATION (2008), <http://www.nahb.org/category.aspx?sectionID=819&channelID=311> (MS Excel file) (last visited Jan. 5, 2009). The increase in floor space does not seem to have been necessary to accommodate larger numbers of children. Among families in the United States having their own children under 18 years of age, the mean number of own minor children declined from 1965 until 1984 and then remained essentially constant: In 1965, the mean number was 2.44; from 1984 to 2007, the mean number was in the range of 1.85 ±.04. U.S. Census Bureau, Families and Living Arrangements, Historical Time Series: Families, *Table FM-3. Average Number of Own Children Under 18 Per Family, By Type of Family: 1955 to Present* (July 2008), <http://www.census.gov/population/www/socdemo/hh-fam.html#ht> (last visited Jan. 5, 2009). Floor space was thus increasing while the number of own minor children was not.

amount of living space acquired by U.S. residents buying a new one-family house increased 37 percent.

- Of all new cars that were sold annually in the United States, the fraction classified as “small” decreased from no less than one in two during the period 1975-1995 to just one in three during 2007.<sup>62</sup>
- The ratio of total household debt—i.e., consumer debt and mortgage debt—to disposable personal income in the United States rose appreciably from the first half of the 1950s to the last half of the 1960s, remained at a plateau until the first half of the 1980s, and then increased rapidly.<sup>63</sup> The result was that, in 2004, total household debt was 108 percent of disposable personal income.<sup>64</sup> While an increase in mortgage debt accounted for most of the growth in household debt, consumer debt materially expanded, too.<sup>65</sup> During the last two decades, Americans thus became steadily more reliant on borrowed money to finance their consumption of goods and services rather than defer consumption until they had accumulated the money for it.<sup>66</sup>

The debt of households, however, is not the sole form of debt that manifests the extent of hedonism, materialism, and short-term thinking in a society. The debt of governments at the state and local level is also a useful indicator. Compared to the federal government, state and local governments are (or at least are widely believed to be) more closely attuned and responsive to the everyday wishes of their respective populations.<sup>67</sup>

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62. STACY C. DAVIS ET AL., CENTER FOR TRANSPORTATION ANALYSIS, TRANSPORTATION ENERGY DATA BOOK 4-7 (27th ed. 2008), [http://cta.ornl.gov/data/tedb27/Edition27\\_Full\\_Doc.pdf](http://cta.ornl.gov/data/tedb27/Edition27_Full_Doc.pdf). Cars are differentiated from and do not include wagons. *Id.* The criteria that were used to classify a car (or a wagon) as “small” are not specified. *See id.* at 4-7, G-2.

63. John A. Weinberg, *Borrowing by U.S. Households*, 92 *ECON. Q.* 177, 179 (2006). Unfortunately, an adjustment was not made for changes in the distribution of age in the adult population of the United States during the period covered by the data. Such an adjustment would have produced a more accurate estimate of the ratio of debt to income of households over time, because the ratio varies by age of the household head. Ana M. Aizcorbe et al., *Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances*, *FED. RES. BULL.*, Jan. 2003, at 1, 22-23.

64. *Id.* at 178.

65. *Id.* at 179. The ratio of minimum debt payments to income—which ratio takes into account, *inter alia*, changes in interest rates and maturities on debt—grew during the mid-1980s, declined until the first half of the 1990s, and then increased. Karen Dynan et al., *Recent Changes to a Measure of U.S. Household Debt Service*, *FED. RES. BULL.*, Oct. 2003, at 417, 420.

66. Personal debt to allow consumption by the individuals incurring the debt or by their children has evidently become more acceptable to Americans. ROBERT D. MANNING, *LIVING WITH DEBT: A LIFE STAGE ANALYSIS OF CHANGING ATTITUDES AND BEHAVIORS* 138-40, A.1 (no date) (reporting the results of interviews conducted in 2005 with 145 individuals at different stages of the life cycle), [http://www.lendingtree.com/livingwithdebt/collateral/full\\_report.pdf](http://www.lendingtree.com/livingwithdebt/collateral/full_report.pdf).

67. *E.g.*, Richard H. Fallon, Jr., *The “Conservative” Paths of the Rehnquist Court’s Federalism Decisions*, 69 *U. CHI. L. REV.* 429, 440 (2002).

Figure 3 provides a yardstick for the debt per capita of state and local governments in the United States during the period from 1960 to 2004. The yardstick was developed with a two-step procedure. In the first step, the number of dollars per capita owed by state and local governments in each year<sup>68</sup> was multiplied by the Consumer Price Index for the same year.<sup>69</sup> In the second step, the amounts obtained in the first step were divided by the amount obtained in the first step for 1983. In Figure 3, therefore, 1983 is the base year, i.e., 1983 is set at 1.00, and the per-capita debt of state and local governments in a given year is the ratio of the per-capita debt in that year to the per-capita debt in 1983. The calculation procedure allows Figure 3 to show change over time in the debt per capita of state and local governments with the purchasing power of U.S. currency held constant.

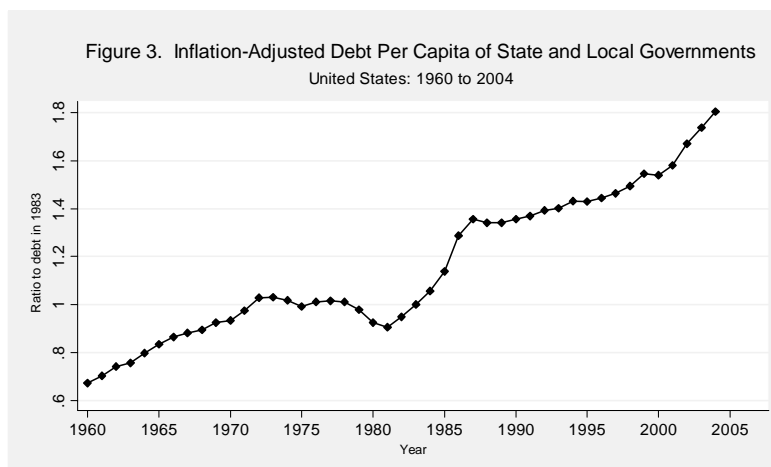


Figure 3 reveals that an increase in the level of indebtedness of state and local governments occurred after 1960 and continued until the first half of the 1970s. From 1972 to 1978, the indebtedness of state and local governments was essentially unchanged, and it then declined slightly until 1982. After 1982, however, indebtedness began a long-term, substantial

68. These amounts were obtained from various issues of U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES, an annual publication whose issues are available at <http://www.census.gov/prod/www/abs/statab.html>, and from U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENTS—INDEBTEDNESS, [http://www.allcountries.org/uscensus/507\\_state\\_and\\_local\\_governments\\_indebtedness.html](http://www.allcountries.org/uscensus/507_state_and_local_governments_indebtedness.html) (last visited Dec. 17, 2008).

69. The base period for the Consumer Price Index was 1982-1984, i.e., the average of prices in 1982-1984 was used to create Consumer Price Index ratios for each year in the time series. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2009 (128th ed. 2008), at 463 (table 702), available at [http://www.census.gov/prod/www/abs/statab2006\\_2009.html](http://www.census.gov/prod/www/abs/statab2006_2009.html).

rise, and in 2004, indebtedness was 1.8 times larger than in 1983. Over the last two decades covered by Figure 3, in short, the constituents of state and local governments sought and obtained infrastructure and services by having these governmental entities borrow the necessary money. The result was an appreciable enlargement of state and local government debt per capita. Because change in the purchasing power of the U.S. dollar has been statistically controlled, the increase in debt from the early 1980s onward that is visible in Figure 3 cannot be attributed to inflation. Nor can the increase be attributed to simple numerical growth in the population because indebtedness has been measured per person.

## B. SOCIAL VALUES AND INTELLECTUAL SKILLS

There is reason to believe that, during the last half of the twentieth century, intellectual acumen among younger cohorts, while rising, was not increasing as rapidly as it had among cohorts that were at the same age at prior points in time.<sup>70</sup> Although relatively little is known about this change—for instance, whether it happened gradually over numerous cohorts or abruptly over just a few cohorts—available evidence strongly suggests that the intellectual abilities of the U.S. population have not been maximized. In 2003, for example, fewer than one out of five U.S. adults 19-64 years old was deemed to be “proficient” in prose and quantitative literacy; one out of eight or nine (depending on age category) was classified as “below basic” in prose literacy; and approximately one out of five was considered to be “below basic” in quantitative literacy.<sup>71</sup>

Scholars have recognized that the emergence of suboptimum intellectual skills creates serious potential problems for the United States,<sup>72</sup> and I believe that it was a factor in the upheaval that took place in the financial sector during 2008. Specifically, I contend that the upheaval in finance,

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70. Michael J. Handel, *Skills Mismatch in the Labor Market*, 29 ANN. REV. SOCIOL. 135, 160 (2003) (reporting “evidence of decelerating growth of human capital and stability in cognitive test scores”). Cf. Thomas Lord, “*Darn it, Professor. Just Tell Us What We Need to Know to Pass Your Course*”, J. C. SCI. TEACHING, Jan./Feb. 2008, at 71.

71. INST. OF EDUC. SCI., NAT’L CENTER FOR EDUC. STAT., THE CONDITION OF EDUCATION 2007: TRENDS IN ADULT LITERACY 155 (table 18-2) (2007), [http://nces.ed.gov/programs/coe/2007/pdf/18\\_2007.pdf](http://nces.ed.gov/programs/coe/2007/pdf/18_2007.pdf). Prose literacy was defined as “the knowledge and skills needed to perform prose tasks (i.e., to search, comprehend, and use information from continuous texts, such as paragraphs from stories).” Quantitative literacy was defined as “the knowledge and skills required to perform quantitative tasks (i.e., to identify and perform computations, either alone or sequentially, using numbers embedded in printed materials.” *Id.* Performance was divided into four levels: below basic, basic, intermediate, and proficient. *Id.* The data cited in the sentence in the text are also available at <http://nces.ed.gov/programs/coe/2007/section2/table.asp?tableID=693>.

72. E.g., Michael Jordan, *Law Teachers and the Educational Continuum*, 5 S. CAL. INTERDISC. L.J. 41, 61-64 (1996).

which was due in large part to imprudent investing and spending by individuals and entities, occurred primarily because (i) hedonism, materialism, and a short-term time horizon became more widespread among Americans and (ii) this change in social values prevented the members (especially the youthful members) of the population from maximizing their intellectual abilities.<sup>73</sup> My thesis rests on the assumption that social values as to hedonism, materialism, and time horizon are intertwined, i.e., are a set of values, and that, if this set is affecting one dimension of a society, it is affecting other dimensions, too. Research has found that, during the 1980s and first half of the 1990s, social values favoring materialism had a negative impact on the level of trust in others.<sup>74</sup> Accordingly, the increased prevalence of social values promoting hedonism, materialism, and time horizon is a plausible factor causing an array of societal problems, including impairment of intellectual skills.

What approach most accurately assesses the intellectual abilities of the population of a country? When countries are competing economically with each other, as they increasingly are, the most appropriate assessment is a comparison of the countries in terms of the performance by their residents on standardized tests. I follow this approach and compare the United States with other countries that are members of the Organization for Economic Cooperation and Development ("OECD"). All comparisons are based on data for fifteen-year-old students in the latest year for which data are available.<sup>75</sup> The comparisons illustrate the disquieting degree to which the intellectual abilities of the U.S. population are wanting. Notably, the general ranking of the United States among OECD countries has been roughly the same for several decades.<sup>76</sup> Accordingly, the intellectual skills of U.S. teenagers in recent years do not merely foreshadow the intellectual skills of the future adult population of the United States; they are also indicative of the intellectual skills of the current adult population.

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73. Grades have markedly increased in colleges and universities in the United States since the 1960s, and the increase in grades has substantially reduced the amount of time that students devote to studying. Philip Babcock, *Real Costs of Nominal Grade Inflation? New Evidence from Student Course Evaluations* 3-4, 7, 18-20 (2008) (unpublished manuscript, on file with author), <http://www.econ.ucsb.edu/~babcock/GradeInflation.pdf>. The inflation of grades and the resulting decline in study time are probably manifestations, at least in part, of the expansion of hedonism, and if so, they support the proposition that the growth of hedonism has impaired the intellectual skills of Americans.

74. Rahn & Transue, *supra* note 44 (reporting an analysis of data from the Monitoring the Future study and finding that the spread of social values endorsing materialism reduced trust in others).

75. In the comparisons in the text, a difference between the United States and another country was judged to be "significant" if the difference would occur in no more than five out of 100 samples randomly drawn from the population of fifteen-year-old students in each country. The calculation of significance was made on the assumption (null hypothesis) that fifteen-year-old students in each country have the same average score. The "significance" of a difference between countries, therefore, is a statistical concept.

76. Eric A. Hanushek, *Our School Performance Matters*, 185 J. EDUC. 1, 1 (2006).

- On four scales measuring mathematics literacy, the average combined score in the United States was significantly lower than the average combined score in twenty of twenty-nine OECD countries; the average combined score in the United States was significantly higher than the average combined score in only five of the twenty-nine countries.<sup>77</sup>
- On three scales measuring science literacy, the average combined score in the United States was significantly lower than the average combined score in sixteen of thirty OECD countries; the average combined score in the United States was significantly higher than the average combined score in just five of the thirty countries.<sup>78</sup>
- On a test of problem-solving ability, the average score in the United States was significantly lower than the average score in twenty-two of twenty-nine OECD countries; the average score in the United States was significantly higher than the average score in just four of the twenty-nine countries.<sup>79</sup>

To conclude part IV, the evidence presented indicates that broad, fundamental change has occurred in the character of U.S. society since the middle of the twentieth century. The evidence is consistent with my thesis that the upheaval in finance during 2008 stemmed from conditions embedded in the fabric of U.S. society rather than merely from mismanagement in the financial sector and/or inadequate government regulation.<sup>80</sup> If the the-

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77. NAT'L CENTER FOR EDUC. STAT., THE CONDITION OF EDUCATION 2006, at 145 (table 17-1) (2006), <http://nces.ed.gov/pubs2006/2006071.pdf>. The data in the text are for 2003. The definition of "mathematics literacy" is: "An individual's capacity to identify and understand the role that mathematics plays in the world, to make well-founded judgments, and to use and engage with mathematics in ways that meet the needs of that individual's life as a constructive, concerned, and reflective citizen." *Id.* at 306.

78. NAT'L CENTER FOR EDUC. STAT., THE CONDITION OF EDUCATION 2008, at 123 (table 19-1) (2008), <http://nces.ed.gov/pubs2008/2008031.pdf>. The data in the text are for 2006. The definition of "science literacy" is: "An individual's scientific knowledge and use of that knowledge to identify questions, to acquire new knowledge, to explain scientific phenomena, and to draw evidence-based conclusions about science-related issues; understanding of the characteristic features of science as a form of human knowledge and enquiry; awareness of how science and technology shape our material, intellectual, and cultural environments; and willingness to engage in science-related issues, and with the ideas of science, as a reflective citizen." *Id.* at 237.

79. NAT'L CENTER FOR EDUC. STAT., INTERNATIONAL OUTCOMES OF LEARNING IN MATHEMATICS LITERACY AND PROBLEM SOLVING: PISA 2003 RESULTS FROM THE U.S. PERSPECTIVE 29 (table 3) (2004), <http://nces.ed.gov/pubs2005/2005003.pdf>. The data in the text are for 2003. The definition of "problem solving" is: "an individual's capacity to use cognitive processes to confront and resolve real, cross-disciplinary situations where the solution is not immediately obvious, and where the literacy domains or curricular areas that might be applicable are not within a single domain of mathematics, science, or reading." *Id.* at 22.

80. Indeed, the change in U.S. society that I describe is likely to explain much of the mismanagement in finance and inadequacy of government regulation that characterized the United States from the 1990s onward.

sis is correct, its implications for the regulation of investment companies in the United States should be explored. I turn now to that task.

## V. THE INVESTMENT COMPANY ACT

In a remarkably short period of time, investment companies have become an important and salient component of the financial resources of Americans. Few developments in the history of finance in the United States are likely to match, in magnitude and speed, the post-1980 embrace of investment companies by Americans and the corresponding growth in the assets of these companies. The significance of U.S. investment companies—particularly mutual funds<sup>81</sup>—may be understood by placing them in a global context: Mutual funds in the United States are responsible for managing more wealth than mutual funds in any other nation as measured by the market value of assets under management.<sup>82</sup> Indeed, in 2007, the net assets of mutual funds in the United States comprised almost half (45.9 percent) of the net assets of all mutual funds in the world.<sup>83</sup> Given this proportion and the strong links now existing between securities markets in the United States and securities markets in other countries,<sup>84</sup> U.S. law on mutual funds is important to the finance sector globally.

What is an investment company under U.S. law? The answer is found in the Investment Company Act (“Act”),<sup>85</sup> which was adopted by Congress in 1940.<sup>86</sup> In general terms, the Act classifies an entity as an investment company if the entity (i) issues securities to individuals and entities in exchange for financial assets, (ii) uses these assets to invest in securities of other issuers, and (iii) is unable to qualify for a statutory exclusion from investment company status.<sup>87</sup> An investment company is thus an entity that pools assets from the holders of its securities, i.e., from its investors, in order to acquire securities issued by others and seek a monetary profit for its securities holders. An entity that is deemed by the Act to be an investment company is subject to the requirements of the Act and to regulation by the Securities and Exchange Commission (“Commission”) pursuant to the Act.<sup>88</sup>

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81. Mutual funds are the dominant form of investment company in the United States. *See generally The Public-Private Dichotomy*, *supra* note 6, at 5-6.

82. *See* INVESTMENT COMPANY FACT BOOK, *supra* note 57, at 157.

83. Computed from *id.*

84. David D. Haddock, *Insider Trading: Academic Hostility and SEC Acquiescence: Henry Manne's Insider Trading*, 50 Case W. Res. L. Rev. 313, 317 (1999) (noting that “United States securities markets have become integrated with those of the rest of the world”).

85. 15 U.S.C. §§ 80a-1 to -64 (2006).

86. Investment Company Act, ch. 686, tit. I, 54 Stat. 789 (1940).

87. § 80a-3.

88. § 80a-37, -41.

The Investment Company Act recognizes different types of investment companies,<sup>89</sup> but in terms of wealth under management, open-end management investment companies<sup>90</sup>—i.e., mutual funds<sup>91</sup>—are the main type. An indicator of the importance of mutual funds in the United States to the finance sector of the country is that the investment portfolios of the funds in December 2008 had a market value of approximately \$9.6 trillion.<sup>92</sup> The wealth managed by mutual funds has important societal ramifications, because 86 percent of it derives from the 44 percent of U.S. households that are fund investors<sup>93</sup> and because it represents fully one-fourth of the retirement assets of U.S. households.<sup>94</sup> Given that Americans widely own mutual funds and have entrusted the funds with a sizeable fraction of their retirement assets, the utility of U.S. law applicable to the funds is of the utmost importance to Americans individually and collectively.<sup>95</sup>

In light of the societal significance of the Investment Company Act, I examine sections of the Act that seem especially pertinent to exigencies in securities markets. In particular, I have chosen sections of the Act for review that may have reduced damage to securities markets from the 2008 upheaval in finance or that, with revision, may minimize such damage from future upheavals.<sup>96</sup> In this regard, the determination of whether these sections were beneficial, or can be altered so that they will be beneficial, should take into consideration the sociological antecedents of the 2008 upheaval. As attributes of U.S. society, the antecedents of the 2008 upheaval can shape the content of U.S. law.<sup>97</sup> They must not, therefore, be ignored in studying law.

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89. § 80a-4, -5.

90. By definition, open-end management investment companies issue redeemable securities. § 80a-5(a)(1). A redeemable security entitles its owner to receive from the company issuing the security the net asset value of the security at the time of redemption. § 80a-2(a)(32). Redemption may occur in cash, or it may occur in kind, i.e., with a security or securities in the portfolio of the company that issued the redeemable security. 17 C.F.R. § 270.18f-1 (2008).

91. *Regulation of Mutual Fund Boards*, *supra* note 6, at 493-94.

92. Investment Company Institute, *Trends in Mutual Fund Investing, January 2009*, ICI STAT. & RES., Feb. 26, 2009, [http://www.ici.org/stats/mf/trends\\_01\\_09.html#TopOfPage](http://www.ici.org/stats/mf/trends_01_09.html#TopOfPage). The market value of fund portfolios, however, had fallen from \$12.0 trillion in December 2007. *Id.*

93. INVESTMENT COMPANY FACT BOOK, *supra* note 57, at 70. The percentages in the text are for 2007.

94. Investment Company Institute, *The U.S. Retirement Market, Second Quarter 2008*, RESEARCH FUNDAMENTALS, Dec. 2008, at 13, [http://www.ici.org/stats/res/1retmrkt\\_update.pdf](http://www.ici.org/stats/res/1retmrkt_update.pdf). The retirement assets of U.S. households comprise 36 percent of their total financial assets. *Id.* at 3.

95. In justifying adoption of the Investment Company Act, Congress explicitly acknowledged the importance of investment companies to “the national public interest and the interest of investors.” § 80a-1(b).

96. Although I argue that law has little direct impact on aspects of and activities in a society that are predominantly *social*, law may be useful for controlling some aspects and activities that are predominantly *economic*. LARRY D. BARNETT, LEGAL CONSTRUCT, SOCIAL CONCEPT 162-63 (1993).

97. *The Roots of Law*, *supra* note 2; *The Public-Private Dichotomy*, *supra* note 6, at 39-40.

## A. SECTIONS 3(c)(1) AND 3(c)(7)

Subsections 1 and 7 of section 3(c)<sup>98</sup> of the Act are based on the public-private dichotomy that is widespread in American society and, hence, in its law.<sup>99</sup> The subsections establish conditions under which an entity will not be classified as an investment company even though the entity would be designated an investment company by section 3(a).<sup>100</sup> An entity that meets the requirements of either subsection is not an investment company under the Act and is not governed by any of the provisions of the Act (with exceptions<sup>101</sup> to be reviewed *infra*<sup>102</sup>).

Subsection 1, which was included in the Act when it was adopted in 1940,<sup>103</sup> covers an entity when the securities that the entity has issued to investors have a maximum of 100 beneficial owners and have not been publicly offered for sale.<sup>104</sup> Congress incorporated subsection 1 into the Act because it wanted to prevent the regulation of “private companies in which there is no significant public interest,”<sup>105</sup> but believed that an entity was operating in the private sphere only if both criteria specified in the subsection were satisfied. An entity cannot escape investment company status through subsection 1, accordingly, unless 100 or fewer persons beneficially own the securities of the entity *and* these securities were sold privately.

Subsection 7, too, is directed at preventing government regulation of private entities,<sup>106</sup> but unlike subsection 1, subsection 7 does not limit the number of investors.<sup>107</sup> Under subsection 7, which was adopted in 1996,<sup>108</sup> an entity is not an investment company if (i) all of its investors (with certain exceptions) are “qualified purchasers” when they acquire the securities issued by the entity and (ii) the offer of the securities to investors is conducted by the entity in a manner that is not public. Because “qualified purchasers” are individuals and entities with investments amounting to no less

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98. § 80a-3(c).

99. *The Public-Private Dichotomy*, *supra* note 6, at 15-18.

100. § 80a-3(a).

101. § 80a-3(c)(1), -3(c)(7)(D).

102. The exceptions are sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i). 15 U.S.C. § 80a-12(d)(1) (2006). *See infra* notes 147, 150 and accompanying text.

103. Investment Company Act, Pub. L. No. 76-768, tit. I, § 3(c)(1), 54 Stat. 789, 798 (1940).

104. § 80a-3(c)(1).

105. Small Business Investment Incentive Act of 1980, H.R. REP. NO. 96-1341, at 35 (1980), *reprinted in* 1980 U.S.C.C.A.N. 4800, 4817.

106. S. REP. NO. 104-293, at 10 (1996), 1996 WL 367191 (stating that the subsection “expands capital formation opportunities by creating a new exception from registration and regulation under the Investment Company Act for private investment pools”).

107. § 80a-3(c)(7).

108. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 209, 110 Stat. 3416, 3433-34 (1996).

than \$5 million,<sup>109</sup> they were presumed by Congress to be experienced, knowledgeable investors.<sup>110</sup>

A vehicle for investing in securities can develop a portfolio that has substantial monetary value, but an entity (e.g., a mutual fund) that is an investment company under section 3 of the Act is subject to section 18 and to the ceiling it imposes on borrowing.<sup>111</sup> A vehicle for investing in securities that satisfies either subsection 1 or subsection 7 of section 3(c), on the other hand, is not classified as an investment company and escapes the limitation on borrowing imposed by the Act. The latter type of vehicle includes hedge funds. Thus, hedge funds, which meet the requirements of one of the subsections, are not circumscribed by section 18 in their ability to borrow.<sup>112</sup> Borrowing, of course, allows a fund to acquire a larger quantity of securities than could be acquired with just the money provided by its investors, and borrowing can thus increase not only profits but losses.<sup>113</sup> Because their investments can be made with an appreciable amount of borrowed money,<sup>114</sup> hedge funds are thought to have played a major role in the marked decline that took place during 2008 in the prices of common stocks and corporate debt securities.<sup>115</sup>

What are the implications for subsections 1 and 7 of the greater prevalence of hedonism, materialism, and short-term time horizon that now characterize the U.S. population? Although the implications are undoubtedly multiple and complex, I discuss just one here. In particular, I believe that one likely result of current social values is that, *ceteris paribus*, hedge funds are able to attract a substantially larger number of individuals as investors than they would otherwise attract, because Americans are more inclined

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109. § 80a-2(a)(51)(A).

110. S. REP. NO. 104-293, at 10 (1996), 1996 WL 367191.

111. § 80a-18. The ceiling for open-end investment companies differs from the ceiling for closed-end investment companies. Periodic Repurchases by Closed-End Management Investment Companies; Redemptions by Open-End Management Investment Companies, Investment Company Act Release No. IC-18869, 57 Fed. Reg. 34,701, 34,704 (Aug. 6, 1992). Congress explicitly identified borrowing by investment companies as a reason for regulating the companies. § 80a-1(b)(7).

112. I discuss hedge funds in more depth in *The Public-Private Dichotomy*, *supra* note 6, at 7-8, 22-23.

113. Securities Trading Practices Of Registered Investment Companies, Investment Company Act Release No. 10666, 44 Fed. Reg. 25,128, 25,129-30 (April 18, 1979).

114. Kevin G. Hall & Robert A. Rankin, *Hedge Funds May Pose a Risk to U.S. Economy*, MCLATCHY NEWSPAPERS Aug. 8, 2007 [page number unspecified], <http://www.mcclatchydc.com/227/story/18766.html> (estimating that hedge funds had assets worth a total of \$1.6 trillion in mid-2007 and that some hedge funds used borrowed money to acquire as much as four-fifths of their assets); David Henry & Matthew Goldstein, *Another Blowup for Hedge Funds*, BUS. WK., Nov. 24, 2008, at 34 (estimating that the amount of money borrowed by hedge funds for investments was six times their capital).

115. Henry & Goldstein, *supra* note 114; Matthew Goldstein & David Henry, *The Hedge Fund Contagion*, BUS. WK., Nov. 3, 2008, at 36. Hedge funds did not avoid the losses that occurred in securities markets. An index of hedge funds in North America was estimated to have had an investment return of -10.25 percent from January 1, 2008 through December 31, 2008. Eurekahedge North American Hedge Fund Index, <http://www.eurekahedge.com/indices/default.asp> (last visited April 1, 2009).

than in the past to seek immediate monetary rewards and consider such rewards obtainable.<sup>116</sup> At the same time, unfortunately, individuals who are willing to entrust financial resources to a hedge fund are not on average as capable of understanding the risks of hedge-fund investments as they would have been with the intellectual skills they could have acquired.

The preceding conclusion, if correct, suggests that subsections 1 and 7 should be amended in a way that appreciably reduces the proportion of the U.S. population that is eligible to invest in hedge funds. For example, the subsections might be revised to mandate that an individual be an “experienced investor” in order to invest as a principal in a hedge fund. The definition of the concept of “experienced investor” would differ from the definition of the concept of “accredited investor” in the Securities Act and Regulation D under the Securities Act.<sup>117</sup> To be an “experienced investor” under the Investment Company Act, an individual would need to demonstrate a personal history of investing in securities, and perhaps other types of property (e.g., commodities),<sup>118</sup> as a principal or as an agent; the personal history would need to have involved the investment of a specified and substantial minimum amount of money; and the investment history would need to have occurred over a designated minimum number of years. Otherwise stated, an entity that, but for subsection 1 or subsection 7, would be an investment company could not accept an individual as an investor under the suggested revision of the subsections unless the individual met standards considerably more restrictive than the current net worth and income standards that an individual is required to meet in order to be an “accredited investor” under Regulation D.<sup>119</sup>

#### B. SECTION 7(d)

As a nation becomes enmeshed in a global economy, it can be expected to experience an increase in cross-country financial activities. With globalization, accordingly, a vehicle for investing in securities that was es-

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116. See Registration under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. IA-2333, 69 Fed. Reg. 72,054, 72,057 (Dec. 10, 2004) (noting “the growing exposure of smaller investors, pensioners, and other market participants, directly or indirectly, to hedge funds” and concluding that “[h]edge fund investors are no longer limited to the very wealthy”).

117. 15 U.S.C. § 77b(a)(15)(ii) (2006); 17 C.F.R. § 230.501(a) (2008).

118. In recent years, hedge funds have invested in commodities as well as in securities. Goldstein & Henry, *supra* note 115, at 38.

119. For an individual, the current standards require that, to be an accredited investor, the individual must have (i) a net worth, alone or jointly with her/his spouse, totaling more than \$1 million, (ii) an annual personal net income of more than \$200,000, or (iii) an annual joint net income with his/her spouse of more than \$300,000. To satisfy (ii) and (iii), the income amounts specified by Regulation D must have been received during both of the last two years and must be reasonably expected during the present year as well. 17 C.F.R. §§ 230.501(a)(5), 230.501(a)(6) (2008).

tablished and is located outside the United States is likely to seek opportunities to recruit investors within the United States. The Investment Company Act, through section 7(d),<sup>120</sup> addresses this situation. The section was designed to prevent a foreign investment company from exposing the U.S. public to risks from activities and arrangements that Congress believed were unacceptable for domestic investment companies.<sup>121</sup>

Section 7(d) applies to an entity the activities of which meet the criteria for an investment company stated in section 3 of the Act but which was formed under the law of a country other than the United States. Unless the entity (i.e., foreign investment company) registers with, and subjects itself to the jurisdiction of, the Securities and Exchange Commission, it and its underwriters are prohibited by section 7(d) from utilizing interstate commerce or mail in the United States (i) to make a public offer to sell the securities it issues or (ii) to sell such securities, or deliver such securities after sale, if the sale/delivery is connected to a public offer. Although section 7(d) is inapplicable to nonpublic offers and sales,<sup>122</sup> section 3(c)(1) allows no more than 100 U.S. residents to invest in a foreign investment company that privately offers and sells its securities using interstate commerce or mail.<sup>123</sup> Section 3(c)(7), on the other hand, permits such a foreign investment company to have an unlimited number of U.S. residents as investors, but only if the investors are qualified purchasers.<sup>124</sup>

While section 7(d) explicitly allows a foreign investment company to engage in a public offering and sale of its securities in the United States by registering with the Commission, registration is possible only if the company meets a series of conditions and secures Commission approval.<sup>125</sup> As a result, section 7(d) is believed to be the reason that just a small number of foreign investment companies have chosen to offer and sell their securities publicly in this country.<sup>126</sup> However, the impact of the section in excluding many foreign investment companies from the United States seems to have had an unintended effect—even public offers and public sales by foreign investment companies that would be advantageous to U.S. investors have

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120. 15 U.S.C. § 80a-7(d) (2006).

121. See SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 189 (1992), available at <http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf>.

122. *Id.* at 190.

123. Touche, Remnant & Co., SEC No-Action Letter, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,810, at 79,138, 79,141-42 (July 27, 1984).

124. See Goodwin, Procter & Hoar, SEC No-Action Letter (Feb. 28, 1997), 1997 WL 86002. The foreign investment company must choose between section 3(c)(1) and section 3(c)(7); it cannot rely on both sections. *Id.*

125. Applications of Foreign Investment Companies Filed Pursuant to Section 7(d) of the Investment Company Act of 1940, Investment Company Act Release No. IC-13691, 49 Fed. Reg. 55 (Jan. 3, 1984).

126. SEC. & EXCH. COMM'N, *supra* note 121, at 189-90, 192.

been prevented.<sup>127</sup> As a result, the Commission recommended in 1973 and in 1984 that Congress amend section 7(d) to expand the conditions under which a foreign investment company can offer and sell its securities publicly in the United States.<sup>128</sup>

Section 7(d) was not revised in response to the recommendations of the Commission.<sup>129</sup> However, during the quarter of a century since the last recommendation was made, the ties between the U.S. economy and the economies of other nations have expanded. The pressure to modify section 7(d) is likely to have intensified, therefore, and an effort to rewrite the section in the foreseeable future would not be surprising.

Should Congress decide to revise section 7(d), the concerns arising from the shift in social values and its impact on intellectual skills, discussed *supra* in part V-A with regard to subsections (c)(1) and (c)(7) of section 3, need to be addressed, both because the concerns have a bearing on foreign investment companies and because the concerns exacerbate a problem that is unique to these companies. The latter—i.e., the problem for section 7(d) that is magnified by the change in social values and its effect on intellectual acumen—involves a principle from the field of linguistics. When a foreign investment company makes a public offer of its securities in the United States, differences between the English language and the language of the country that is the home of the foreign investment company pose a potential hurdle to preparing a prospectus that communicates, effectively and thoroughly, concepts that are important to U.S. investors.<sup>130</sup> Concepts are conveyed by inter alia words in a language, but a word typically has multiple referents and can carry subtle connotations. Because the meaning of a word depends on the situation and culture<sup>131</sup> in which the word is utilized,<sup>132</sup> the concept represented by a word in one language may not be fully

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127. *Id.* at 198.

128. *Id.* at 193-94, 198-200. The Division of Investment Management, which is the unit within the Commission that is responsible for interpreting the Investment Company Act, has also suggested changes to section 7(d). *Id.* at 205-14. The proposals of the Commission and of the Division were made before section 3(c)(7) and section 2(a)(51) were added to the Act in 1996. Pub. L. No. 104-290, § 209, 110 Stat. 3416, 3433-34.

129. Indeed, section 7(d) has not been amended since the Investment Company Act was adopted in 1940. See Investment Company Act, ch. 686, tit. I, § 7(d), 54 Stat. 789, 803 (1940).

130. See Benjamin Lee Whorf, *Science and Linguistics*, in LANGUAGE, THOUGHT, AND REALITY: SELECTED WRITINGS OF BENJAMIN LEE WHORF 207 (John B. Carroll ed. 1956). Whorf, a leading linguist, described the function of language as follows: “[T]he world is presented in a kaleidoscopic flux of impressions which has to be organized by our minds—and this means largely by the linguistic systems in our minds. We cut nature up, organize it into concepts, and ascribe significances as we do, largely because we are parties to an agreement to organize it in this way—an agreement that holds throughout our speech community and is codified in the patterns of our language.” *Id.* at 213.

131. Benjamin Lee Whorf, *The Relation of Habitual Thought and Behavior to Language*, in *id.*, at 134, 152-59; Naomi Quinn & Dorothy Holland, *Culture and Cognition*, in CULTURAL MODELS IN LANGUAGE AND THOUGHT 3, 7 (Dorothy Holland & Naomi Quinn eds., 1987).

132. *Towne v. Eisner*, 245 U.S. 418, 425 (1918) (observing that “A word is not a crystal, transparent and unchanged[;] it is the skin of a living thought and may vary greatly in color and content accord-

understood, let alone correctly explained, by persons who have been reared in another language.<sup>133</sup> If section 7(d) is to be amended so that a larger number of foreign investment companies are permitted to recruit investors from the U.S. public, Congress as well as the Commission will need to confront the problems of communication posed by differences between English and the language(s) used in the country of a foreign investment company that seeks Commission approval to offer and sell shares of the company publicly in the United States. This problem is made more difficult by the suboptimum intellectual skills of the U.S. population, but it may be mitigated if a rule of the Commission under section 7(d), as revised, mandates that a foreign investment company must have its English-language prospectus and sales materials written by an individual (i) who is fluent both in English and in the language(s) of the home country of the investment company, *and* (ii) who has lived for an appreciable period in both the United States and the home country.<sup>134</sup> Residence in the home country allows an individual to learn the subtle meanings of words that are difficult, if not impossible, to acquire through language training in a classroom located elsewhere.

### C. SECTION 12(d)(1)

An investment company that buys or otherwise comes to own more than a small percentage of the shares issued by one or more other investment companies—i.e., a fund of funds—poses a number of risks beyond those that are common to all securities investments. Not surprisingly, the investors in a fund of funds are subject to such risks. Moreover, when redeemable shares<sup>135</sup> are issued by a fund of funds to its investors and are acquired by a fund of funds for its portfolio, a number of risks exist for the investment companies that are in the portfolio of a fund of funds, and even for the financial sector as a whole.

Two risks of a fund of funds merit attention here. The first is that the investors in a fund of funds may be unaware of all of the types of securities

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ing to the circumstances and the time in which it is used”).

133. See Whorf, *supra* note 130; Whorf, *supra* note 131.

134. The preceding mandate could also require that the persons who prepare the English-language prospectuses and sales materials must be recognized for their language competence. The word “recognized,” as it would apply in section 7(d), is admittedly ambiguous, but another section of the Investment Company Act contains a word with a not-dissimilar degree of ambiguity. Specifically, section 17(g) directs a registered management investment company to have a bond that covers losses from larceny and embezzlement of portfolio securities by officers and employees of the company. Section 17(g) and its implementing Commission rule explicitly limit the issuer of the bond to a “reputable” insurance company. 15 U.S.C. § 80a-17(g) (2006); 17 C.F.R. § 270.17g-1(a) (2008). The word “reputable” is not defined in the section or the rule.

135. See *supra* note 90.

in which they have a financial interest and may not recognize when a fund of funds has a potential for investment losses that is substantially greater than the investors realized.<sup>136</sup> The risk arises because investors in a fund of funds have a financial interest in securities not just directly but indirectly as well—the investors in a fund of funds own shares of the fund of funds, and they also have an interest in the securities that comprise the portfolios of the underlying funds, i.e., the individual funds that are currently held by the fund of funds. Complexity is thus built into a fund of funds, and the complexity is not conducive to a full understanding of the character of a fund of funds by its investors.<sup>137</sup>

The second risk of a fund of funds exists if the fund of funds issues redeemable shares to its investors and owns redeemable shares issued by other investment companies (“underlying funds”). A redeemable share requires its issuer to transfer cash or securities in its portfolio to the redeeming party in an amount equal to the current market value of the share redeemed.<sup>138</sup> In the context of a fund of funds, the risk stemming from redeemable shares can materialize in at least three ways.

First, a fund of funds that issues redeemable securities may experience a substantial redemption from its investors and be forced to redeem shares of some or all underlying funds. Second, even though investors in the fund of funds are not withdrawing, a fund of funds may decide to exercise its right to redeem shares of underlying funds. In either event, a redemption demand made on a single underlying fund that manages sizeable assets, or on numerous underlying funds that in combination manage sizeable assets, can force the underlying fund(s) to sell a large quantity of portfolio securities. The result may be an appreciable decline in the market price of the portfolio securities that are sold, and even in the market price of securities generally.<sup>139</sup>

A third way in which redeemable securities held by a fund of funds can create risk is that the fund of funds may threaten, explicitly or implicitly, to redeem shares of an underlying fund. The potential for a significant redemption by a fund of funds can lead to actions by the underlying fund that would otherwise not occur. For example, concern with a potential redemption can affect decision making by the manager of the underlying fund as to the amount of cash to have on hand and as to particular securities to have in the portfolio of the fund.<sup>140</sup> The Investment Company Act, how-

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136. H.R. REP. NO. 89-2337, at 322 (1966); Fund of Funds Investments, Investment Company Act Release No. IC-26198, 68 Fed. Reg. 58,226, 58,227 (Oct. 8, 2003) [hereinafter Release No. IC-26198].

137. Release No. IC-26198, *supra* note 136, at 58,227.

138. An open-end investment company that is registered with the Commission must redeem its securities within seven days unless exceptional circumstances are present or an order has been obtained from the Commission allowing the company additional time. 15 U.S.C. § 80a-22(e) (2006).

139. H.R. REP. NO. 89-2337, at 316-17 (1966).

140. H.R. REP. NO. 89-2337, at 315-17 (1966); Release No. IC-26198, *supra* note 136, at 58,226-

ever, was adopted partly because of the damage to the public welfare inflicted by investment companies that were responsive to the wishes of other investment companies or the persons controlling the latter.<sup>141</sup>

The above risks were among those that subsections (A), (B), and (C) of section 12(d)(1)<sup>142</sup> were designed to reduce or eliminate, especially insofar as the risks emanate from funds of funds located outside the United States.<sup>143</sup> These subsections impose quantitative limits<sup>144</sup> on an investment company in acquiring the shares of another investment company and/or in selling its shares to another investment company,<sup>145</sup> unless each of the investment companies is not (and need not be) registered with the Securities and Exchange Commission. However, as pointed out in part V-A *supra*, subsections (A)(i) and (B)(i) of section 12(d)(1) apply to an investment vehicle that, while satisfying section 3(a) of the Act, is not required to register because the vehicle meets the requirements of either section 3(c)(1) or section 3(c)(7).<sup>146</sup> Such a vehicle is subject to subsections (A)(i) and (B)(i) of section 12(d)(1) even though it is otherwise not regarded by the Act as an investment company.

Under subsection (A)(i),<sup>147</sup> an investment company can currently own a maximum of 3 percent of the outstanding voting shares of any other investment company, a limit that is supplemented in subsection (A)(ii)<sup>148</sup> by a requirement that the acquiring investment company commit no more than 5 percent of its assets (measured by market value) to securities issued the acquired investment company. An additional restraint is contained in subsection (A)(iii),<sup>149</sup> which allows an investment company to invest a maximum of 10 percent of the market value of its assets in securities issued by two or more investment companies.

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27. See 15 U.S.C. § 80a-1(b)(2) (2006).

141. § 80a-1(b)(2).

142. § 80a-12(d)(1)(A)-(C). Subsections (A), (B), and (C) were added in 1970. Investment Company Act Amendments of 1970, Pub. L. No. 91-547, § 7, 84 Stat. 1413, 1417 (1970).

143. Cheapside Dollar Fund Ltd., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,389, at 80,872, 80,873 (Aug. 26, 1971), available at 1971 WL 11137.

144. The limitations are subject to exceptions. § 80a-12(d)(1)(D)-(G).

145. As to the securities specified in subsections (A), (B), and (C) of section 12(d)(1), the calculation of whether an investment company, in acquiring securities issued by another investment company, surpasses each statutory maximum is made by counting not only the securities owned by the acquiring investment company but also the securities owned by a company controlled by the acquiring investment company. § 80a-12(d)(1)(A)-(C). To simplify the discussion in the text, however, I will refer just to the acquiring investment company.

146. §§ 80a-3(c)(1), -3(c)(7)(D). Although a fund that invests in hedge funds must abide by subsections (A)(i) and (B)(i) of section 12(d)(1) in spite of qualifying under section 3(c)(1) or section 3(c)(7), funds of hedge funds evidently exacerbated the declines in securities prices that occurred during 2008. Henry & Goldstein, *supra* note 114.

147. § 80a-12(d)(1)(A)(i).

148. § 80a-12(d)(1)(A)(ii).

149. § 80a-12(d)(1)(A)(iii).

Under subsection (B)(i),<sup>150</sup> an open-end investment company that is (or that is required to be) registered with the Commission cannot sell its voting shares to another investment company, whether or not registered, if the open-end investment company is aware that the sale will result in ownership of more than 3 percent of its outstanding voting shares by the acquiring investment company. Subsection (B)(ii),<sup>151</sup> furthermore, allows such sales only if a maximum of 10 percent of the outstanding voting shares of the open-end investment company will be owned by two or more investment companies, whether registered or unregistered.

Subsection (C) is the counterpart of subsection (B) for a closed-end investment company, i.e., a fund that issues nonredeemable securities.<sup>152</sup> Under subsection (C),<sup>153</sup> a maximum of 10 percent of the outstanding voting shares of a registered closed-end fund can be acquired by a registered investment company or an unregistered investment company.<sup>154</sup> Because of subsection (C), accordingly, a fund of funds that includes, or wants to include, a registered closed-end fund in its portfolio is subject to the same quantitative limit that subsection (B)(ii) applies to a registered open-end fund.

Congress believed that subsections (A), (B), and (C) were adequate to deal with the risks that it concluded funds of funds posed to the public welfare,<sup>155</sup> but Congress adopted the subsections in 1970.<sup>156</sup> Since then, almost four decades have elapsed, and the United States has undergone considerable change. Given the shift in social values and its effect on intellectual skills (as described *supra* in part IV), has the ability of the subsections to handle the risks posed by funds of funds been undermined?

In answering the question, I begin with the problem that investors in a fund of funds will not thoroughly understand the types of securities that determine the investment performance of the fund of funds. This problem is likely to have been exacerbated by the changes that have occurred in U.S. society over the last four decades. Compared to the decades that preceded the last quarter of the twentieth century, a larger proportion of Americans today, *ceteris paribus*, probably can be attracted to investment vehicles that seem to produce substantial profits quickly. However, because of changes

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150. § 80a-12(d)(1)(B)(i).

151. § 80a-12(d)(1)(B)(ii).

152. § 80a-5(a)(2).

153. § 80a-12(d)(1)(C).

154. To ascertain whether the maximum has been exceeded, the shares of the closed-end fund held by the acquiring investment company and companies under the control of the acquiring investment company are added to the shares of the closed-end fund held by other investment companies that employ the same investment adviser. *See supra* note 145.

155. S. REP. NO. 91-184, at 30 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4925, *available at* 1969 WL 4981; H.R. REP. NO. 91-1382, at 11, 23 (1970).

156. Investment Company Act Amendments of 1970, Pub. L. No. 91-547, § 7, 84 Stat. 1413, 1417 (1970).

in U.S. society, the intellectual skills of Americans are lower than would otherwise be the case. The result is that an unnecessarily large proportion of investors are drawn to a type of investment vehicle that they do not fully understand because they lack the intellectual acumen to formulate relevant questions and analyze the information that such questions would uncover.

A second problem created by societal change since the middle of the twentieth century involves the potential for conflicts of interest in a fund of funds. In judging whether subsections (A), (B), and (C) adequately safeguard the public welfare at the present time, consideration should be given to a statutory exception to the quantitative limits of the three subsections. The exception is in subsection (G) of section 12d(1),<sup>157</sup> which subsection was added in 1996.<sup>158</sup> In pertinent part, subsection (G) authorizes a family of open-end investment companies that are registered with the Commission to establish and offer publicly a registered open-end investment company that confines its portfolio to other open-end funds in the family and certain other types of securities.<sup>159</sup>

Conflicts of interest are a central concern of the Investment Company Act,<sup>160</sup> and such conflicts are more than a remote possibility when a fund invests in funds within the same family. Indeed, conflicts of interest may be unavoidable when a fund of funds belongs to the same set of investment companies as its underlying funds. An investment adviser has a fiduciary duty to each of its clients,<sup>161</sup> but if all of the funds involved in a fund of funds created under subsection (G) are served by the same investment adviser—i.e., if the selection of portfolio securities for the fund of funds and for the underlying funds is the responsibility of a single investment adviser—the loyalties of the investment adviser are divided. In serving the fund of funds, the adviser has a duty to make the decisions that are best for the fund of funds, but in serving the underlying funds, the adviser is obligated to be loyal to the underlying funds. Because situations can develop that require the fund of funds to act in a manner that is harmful to one or more of the underlying funds, the interests of the fund of funds can diverge from the interests of one or more underlying funds.

To illustrate, assume that a family of funds has established a fund of funds pursuant to subsection (G) and that fund X and fund Y in the family

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157. § 80a-12(d)(1)(G).

158. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 202, 110 Stat. 3416, 3426-27 (1996).

159. A fund of funds created under subsection (G) and its underlying funds are subject to certain restrictions, including limits on sales loads and distribution-related fees, but the restrictions are not relevant to the discussion here.

160. Provisions of the Act that are concerned with conflicts of interest include sections 1(b)(2), 2(a)(19), 10(a), 10(b), 15(c), and 17(a) through 17(e).

161. *Investors Research Corp. v. Sec. & Exch. Comm'n*, 628 F.2d 168, 176 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. IC-26299, 68 Fed. Reg. 74,714, 74,720 n.68 (Dec. 24, 2003).

are eligible for the portfolio of the fund of funds. Assume further that the investment objective, strategy, and/or performance of fund X appreciably change and that fund X has become more suitable than fund Y to the fund of funds. Assume finally that the fund of funds currently invests in fund Y and that its investment in fund Y is a significant percentage of the assets of fund Y. In this situation, the fund of funds should substitute fund X for fund Y, but the substitution will work to the detriment of fund Y because the latter will lose a significant portion of its assets. If the same entity is the investment adviser to the fund of funds, to fund X, and to fund Y, the adviser suffers from an irreconcilable conflict of interest. On behalf of the fund of funds, the adviser should mandate the substitution by ordering that the fund of funds redeem the shares of fund Y it holds and use the proceeds of the redemption to purchase shares of fund X. On behalf of fund X, the adviser should welcome this decision. However, on behalf of fund Y, the adviser should oppose the substitution. The action by the investment adviser that is required for one client in the above situation is incompatible with the action that is required for another client, preventing the investment adviser from fulfilling its fiduciary duty both to the fund of funds and to fund Y.

Whether the situation involves the investment adviser or the directors,<sup>162</sup> conflicts of interest are bound to arise in a fund of funds in the same family. The change in social values in the United States and its impact on intellectual skills during the last half of the twentieth century are pertinent to open-end funds that invest in other open-end funds in the same family of funds. While the arrangement is grounded on economic and business considerations,<sup>163</sup> its ramifications are unlikely to be fully appreciated by investors when the funds are served by the same investment adviser or governed by boards of directors that are composed of the same individuals. The defensibility of subsection (G), in short, may have been eroded by change in social values, which reduced the inclination of Americans to commit the time necessary to investigate an unfamiliar, complex vehicle for investing in securities and impaired the analytical skills they need to understand it.

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162. If individuals who are on the board of directors of a fund of funds also serve as directors of each underlying fund, they would have a duty of loyalty to every fund and, in the situation illustrated in the text, would be subject to a conflict of interest. *In re* Vanguard Special Tax-Advantaged Retirement Fund, Inc., Investment Company Act Release No. 14361 (Feb. 7, 1985), 1985 SEC LEXIS 2236, at \*12 to \*14 (Commissioners Treadway and Peters, dissenting).

163. *In re* Vanguard Special Tax-Advantaged Retirement Fund, Inc., Investment Company Act Release No. 14153, 49 Fed. Reg. 36,582. (Sept. 18, 1984).

## VI. CONCLUSION

Probably all societies are characterized by significant inertia, but an unwillingness of their individual members to change is not the reason, or at least not the chief reason, that a society typically exhibits constancy over time. Individuals reside in a social system, which is composed of interdependent components with self-sustaining features such as enforcement mechanisms and feedback loops. A society, therefore, is structured to behave in the same manner and to move in the same direction as it has in the past, and in the normal course, the properties of a society do not change rapidly.<sup>164</sup> Evolution, not revolution, typifies a social system and the patterns of behavior in it.

Given the inertia that characterizes social life, can a society reorganize quickly in response to an event that poses a serious, recognizable threat to it or to one of its central components? The upheaval in finance that occurred during 2008 is evidently such a threat to the United States, but whether the upheaval will swiftly and substantially alter the direction of the country seems improbable. Even in the unlikely event that the social values of Americans were to be suddenly transformed,<sup>165</sup> the level of intellectual skill created in the population by the set of values that were displaced cannot be materially raised in a brief period. The change in social values that has been the focus of the instant article will thus have long-lasting consequences. Two illustrations may help to underscore this point. First, a high level of monetary debt in a country will be reduced only insofar as income can be and is diverted from other uses to debt repayment. However, such a diversion will create difficulties for the uses to which the money was formerly devoted, will encounter resistance from the sectors of the economy that depended on these uses, and will be retarded by the social values that promoted these uses. Second, if the cognitive skills of individuals decline after young adulthood, as research in psychology suggests they do,<sup>166</sup> suboptimum analytical ability will be eliminated or made less common in a population mainly by the passage of decades as mortality removes the now-

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164. Societal properties are measured as means, medians, rates, proportions, and percentages. Such measures are inherently resistant to rapid change.

165. Social values on at least some topics are evidently altered by events, i.e., by one or more occurrences that take place during a given period of time and that have a largely uniform impact throughout the population. Karin L. Brewster & Irene Padavic, *Change in Gender-Ideology, 1977-1996*, 62 *J. MARRIAGE & FAM.* 477, 485-86 (2000); David J. Harding & Christopher Jencks, *Changing Attitudes toward Premarital Sex: Cohort, Period, and Aging Effects*, 67 *PUB. OPINION Q.* 211, 225 (2003). However, the magnitude of period effects, especially relative to the magnitude of the effects of aging and of differences between cohorts, has yet to be established for social values generally. Unfortunately, the effects of the three factors (i.e., age, cohort, and period) cannot be readily separated. Norval D. Glenn, *Cohort Analysis*, 5 *QUANTITATIVE APPLICATIONS IN THE SOCIAL SCIENCES* (1977).

166. Timothy A. Salthouse, *What and When of Cognitive Aging*, 13 *CURRENT DIRECTIONS PSYCHOL. SCI.* 140 (2004).

older individuals, i.e., the individuals with suboptimum ability. In short, neither problem—heavy debt or deficient intellectual skill—can be cured rapidly.

The thesis of the instant article, then, is that a social problem not only can generate an economic problem but that, when it does so, the social problem will impede a solution to the economic problem. Further, a social problem will be resistant to solution if, as is likely, the social problem is embedded in the fabric of the society in which it is found. As a result, while the institutions of a society are connected to one another, the links do not ensure that change needed in the economy will be supported or facilitated by another institution or by properties of the society as a whole (including social values). On the contrary, change required in the economy of a country may be retarded by social conditions in the country.

The thesis of the article is also pertinent to the institution of law and to its role in U.S. society. Because social problems that have arisen from the fabric of a society are difficult to remedy, law should not be expected to yield instant and visible results when it is directed at these problems. Notably, an appreciable number of well-designed studies suggest that law has no more than a modest impact on a variety of social patterns.<sup>167</sup> Accordingly, while the current upheaval in finance can be expected to produce change in law bearing on finance<sup>168</sup>—with new statutory provisions enacted by Congress and new rules promulgated by executive-branch agencies—the rewritten law should not be expected to reshape, markedly and promptly, the social conditions underlying the crisis in the financial sector. Given the empirical evidence currently available, social engineering, whether attempted through law or through another institution such as religion, seems unable to effect permanent, substantial change in a society, at least if the society is a democracy.

Nonetheless, law is important sociologically. The importance of law, however, lies in its *social products*—or perhaps I should say *social by-products*—rather than in its ability to alter the frequency of targeted social activities. Specifically, law benefits a society through the symbols it furnishes, the reputations it helps entities to rebuild, and the trust it promotes in entities and in institutions.<sup>169</sup> Law, in other words, aids a society by increasing social integration, and by doing so, it can help to cure problems

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167. See *supra* note 6.

168. See Press Release, The White House, Declaration of the Summit on Financial Markets and the World Economy ¶ 9 (Nov. 15, 2008), <http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html> (statement of leaders of twenty nations calling for increased government regulation of finance).

169. *Regulation of Mutual Fund Boards*, *supra* note 6, at 546, 548-49. An “entity” refers here to an identifiable organization that has a legally recognized form, e.g., a corporation or a partnership. An “institution” refers to a widespread type of interpersonal activity in a society that is essential to the functioning of the society. A dictionary definition of the concept of “institution” is given *supra* in note 3.

that the society faces. The contribution of law to reducing social problems, however, is indirect, which prevents law from having an impact on such problems that is both immediate and large.

In the long run, the upheaval in the finance sector that was experienced during 2008 may help to alter prevailing assumptions about law, and if so, it will have educational value. The role that law evidently plays in the United States differs from the view of law that has been common among Americans for almost half a century—a view that, simply stated, is wrong. Rather than being an effective tool with which to confront social problems, as is popularly believed, the institution of law is a response to and is molded by the society in which it exists.<sup>170</sup> This view, of course, is contrary to the hopes that many advocates and their supporters have for law, but such hopes are based on overly optimistic assumptions. Until Americans come to accept that law does not offer speedy, permanent solutions to their social problems—until Americans become realistic as to the role of law in society—there will be unnecessary public frustration with the political process and unnecessary public disillusionment with the institution of law.

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170. For example, higher rates of homicide in U.S. counties have been found to lower the probability of conviction for defendants charged with homicide and to shorten the length of the prison terms that such convicted defendants receive. Mark Cooney & Callie Harbin Burt, *Less Crime, More Punishment*, 114 AM. J. SOCIOLOGY 491 (2008). Homicide thus does not seem to be deterred by punishment occurring through the institution of law, i.e., by conviction and imprisonment. *Id.* at 494-95, 514. The finding, if applicable to all types of crime, adds to the evidence in note 6, *supra*, that patterns of social behavior in a society have a material effect on, but are not materially affected by, the institution of law in the society.

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