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# The Moral Undercurrent beneath the Regulatory Regime of Investor Protection

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# The Moral Undercurrents beneath the Regulatory Regime of Investor Protection

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## Introduction

SEC 10b-5 has been successful in prosecuting corporate fraud, mainly because the regulation was written broadly, casting a wide net. 10b-5 also can be thought as an enactment of a moral principle, ‘do not steal.’ If a rule that materializes a moral principle proves to be effective, why should we stop at 10b-5? The author argues that financial regulators and law makers should explore traditional moral rules to get inspired, and to write regulatory rules and laws that carry the spirits of such moral rules. This paper provides familiar moral rules that can be applied to protect investors and thus our economy as a whole. The paper will examine seven moral principles and its relevance in investor protection.

Moral #1: Do not spare rod, lest you should spoil your child.

Many politically conservative commentators have criticized SOX and DFA for overregulation. They argue that (1) those laws has no positive effect on corporate performance; and (2) drive firms offshore, who flee out of the country to avoid the new regulations. Regarding the second point that regulations drive some firms out of our domestic market, the author argues that the concern of the critics are exaggerated. True, some firms will either turn their companies into private companies or move offshore. But not every firm will. Congress should not be too sensitive on such market movements, but rather, stand firm and do the right thing, like a good leader. If Congress starts to be swayed by a handful of companies, it will spoil the whole market. Congress should exercise tough love on financial market. Yes, some companies will run away, and let them do so. If they are too regulation-averse, it is more likely than not that those companies are immoral and perhaps deleterious to the market in the long run anyway. Overregulation does increase the cost of compliance unnecessarily, so it is a bad thing. However, that does not mean every regulation is an overregulation.

A critic of governmental regulation on business may object to the paternalistic idea, or attitude, of the application of the moral maxim above. It may sound crude, but is true that paternalism is the whole reason of having a government. The government exists to make laws

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<sup>1</sup> J.D. candidate, 2015, University of Michigan Law School. The author is obliged to extend a deep gratitude to the professors who guided him, and to colleagues who inspired him, in Michigan Law. This is an academic paper, but the author used the ‘plain English’ approach in order to engage the readers more organically than otherwise would be with a rigid scholarly tone.

(Congress), executes laws (executive branches and agencies), and adjudicate laws (judiciary). And laws govern human behaviors. The reason why the government tells citizens what to do or what not to do by laws is the same reason why a father tells a child to do or not to do: the wellbeing of the child, or the wellbeing of the citizens.

The assessment of the commentators on the first point that SOX/DFA is not effective, is not thoroughly reasoned. Like most people are law-abiding citizens, most corporate managers do not cheat, at least not in the scale of Enron or WorldCom. Thus, it is well expected that SOX/DFA will not make a huge difference in those majority of companies, since they will not commit fraud anyways, whether there is a specific law forbidding fraudulent actions or not. It is those handful of immoral corporate managers that SOX/DFA are targeting. And thus the efficacy of SOX/DFA should be measured not based on the 99% of companies who are moral, but 1% of companies who are immoral<sup>2</sup>. Since the advent of SOX, there was no accounting scandal commensurate to Enron/WorldCom, and thus we may call SOX a success, a deterrence measure that works.

Now, one may wonder, then, why SOX could not have prevented the 2008 Great Recession. The problem is, immorality evolves. Wallstreeters are not murderers and thieves with knives and guns, but are highly educated, highly sophisticated, some of the most brilliant ones in our nation and the world. And like anywhere else, 1% of the talented people in Wall Street are immoral. The immoral Wallstreeters know how to mutate. If a regulation, say SOX, forbids them from accounting book cooking, they move on to invent another way to make quick money. They popularized securitized subprime mortgage instruments. Then spun off the bottom tranche of subprime mortgage security into another whole securitized tranches that they call Collateralized Debt Obligation (CDO)<sup>3</sup>. Then these financial rocket scientists spun off once again the bottom tranche of CDO into another securitized tranches, and called it CDO squared<sup>4</sup>. The tower of Babel keeps on getting higher still: they invented synthetic CDO<sup>5</sup> a gambling bet in essence, based on performances of subprime securities and their progenies. The trouble is that the subprime Babel Tower was built upon a pile of sand. Why? It is because the Wall Street was ignoring the traditional principle of finance that you should not lend money to those who cannot afford to pay back. Also, they ignored the maxim that what goes up must come down. The population and economy of the U.S. is not growing as fast as that of the housing market, and there are just not enough people to buy all the new houses. And for the subprime market, people

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<sup>2</sup> The percentages used here are for demonstration purpose only rather than statistical figures. The point is that most people abide by the law and people in financial market are no exceptions.

<sup>3</sup>For technical definitions of CDO and CDO squared, see Collateralized Debt Obligation (last visited Apr. 10, 7:10 PM), [http://en.wikipedia.org/wiki/Collateralized\\_debt\\_obligation](http://en.wikipedia.org/wiki/Collateralized_debt_obligation). For the mechanisms of them, see Michael Durbin, All about Derivatives 206-211 (2d ed. 2011). Basically, CDO is a scheme to raise the ratings of subprime-based securities from BBB to AAA by calling them with different names.

<sup>4</sup> *Id.*

<sup>5</sup> See Synthetic CDO (last visited Apr. 10, 8:10 PM), [http://en.wikipedia.org/wiki/Synthetic\\_CDO](http://en.wikipedia.org/wiki/Synthetic_CDO). Synthetic CDO was invented because there were more investors and their money than there were CDO's available for sale. Synthetic CDO uses credit default swap mechanism so that an investor can bet on either price rise or price fall of underlying subprime mortgages or their progeny CDO's.

do not just start to make more money by buying a house, and thus most of the subprime home purchasers are bound to default. The entire subprime market was one gigantic short-term thinking, a financial myopia.

Nonetheless, some immoral Wallstreeters started to blow the subprime balloon anyways, because whether a market is based on sound economic substance or not, if the market hype attracts enough investors, they can make quick money off them, before the balloon pops. SOX did not foresee this, and that is why Congress legislated DFA. Of course, critics may say that both SOX and DFA came in a moment too late. They also may say that SOX/DFA are unnecessary to prevent any such wrongdoings, because people will no longer commit Enron/WorldCom-style accounting fraud or invest in subprime market anyway. The critics may say, who would anyone invest in subprime when they already saw how it all collapsed, and who would cook books like Enron/WorldCom, when their fraudulent methods have been divulged out in the open for everyone to see? But we should recall the maxim, 'we repeat mistakes in the history unless we learn from the history.' People may not repeat the mistakes of subprime and accounting scandal for a while, when the memory is still fresh. But decades from now, when the chapter of 2001-2010 in the book of financial history gets dusty, people will forget. Some may commit the same kind of frauds or bubble-making, and SOX/DFA are there to stop such repetition of bad history.

And what about the next mutation of immoral Wallstreeters? Congress should be vigilant, and keep legislating laws as they did SOX and DFA. That is what white the blood cells in our body does: as virus mutates, our immune system produce antigens that fit and capture the newly mutated shapes of viruses. But can we do better? Can Congress be proactive rather than reactive? Is it possible to make a law that can prevent the invention of immoral Wallstreeters?

Moral #2: Do not bite the feeding hand.

Technically speaking, should SEC 10b-5 of 1942 have been enough to prevent Enron/WorldCom accounting fraud? 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

What Enron/WorldCom did was to make untrue statements in their accounting books in order to misrepresent their companies to investors into the beliefs that the companies are making big

money when they are not. So the two companies were lying, but not in connection with purchase or sale of their stocks and bonds, strictly speaking. What they aimed by cooking books is to keep their stock price up, and keep their investors in, so that they keep their companies up and running even though the companies are not producing products that sell. This way, the company managers are deceiving their investors who pay them money, who will eventually lose money because of such deception. That is, the company managers are biting the hands that feed them. This is a highly immoral act<sup>6</sup>.

Suppose Congress/SEC makes a new law/rule that is broader in scope than 10b-5, or simply amends 10b-5 so that it broadens the rule. The new 10b-5 may simply omit 'the purchase or sale of,' to just say that '... in connection with any security.' Then, the rule would have captured the Enron/WorldCom-style fraud<sup>7</sup>. As a matter of fact, the existing 10b-5 is the broadening of 1933 Securities Act law that prohibits fraudulent 'sale' of securities. 10b-5 broadens the rule to include fraudulent 'purchases' as well, so as to prohibit insider trading<sup>8</sup>. The existing 10b-5 is deemed one of the most important prosecutorial tool to punish corporate misbehaviors. And it is a rule that broadened a previous rule. By broadening a rule, the rule becomes more generalized, and approximates closer and closer toward a moral maxim. For instance, the amendment of 10b-5, as suggested above, may be broadened even more, to state:

It shall be unlawful for any company to defraud or make untrue statements or mislead its investors in its securities.

In other words, "do not bite the feeding hands." This way, a regulation can be proactive, rather than reactive, as the net is broader and more general. An immoral Wallstreeter may invent a brand new way to defraud investors, but as long as it is a fraud, the newly broadened 10b-5 above will catch it.

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<sup>6</sup> For instance, no one has a legal duty to say 'thank you' to one's benefactor. It is a moral duty to express gratitude, and sometimes, to return the favor in some way. But if one not only omits to say 'thank you,' but also insults one's benefactor in return for a kind charity, such act is as bad as it gets. An astonishingly egregious phenomenon in financial market is to refer investors as 'fools.' See Martin Zwilling, *Don't Hurt Friends and Family Investors Who Love You*, Forbes (Apr. 16, 2013) (last visited May 7, 2015, 10:23 AM), <http://www.forbes.com/sites/martinzwilling/2013/04/16/dont-hurt-friends-and-family-investors-who-love-you/>. So-called "three F's" of initial investors refers to Friends, Family, and Fools. Even some of academic authors brazenly refer investors as "suckers and fools." See John H. Walsh, *Can Regulation Protect "Suckers" and "Fools" from Themselves? Reflections on the Rhetoric of Investors and Investor Protection under the Federal Securities Laws*, 8 J. Bus. & Sec. L. 188, 188 (2007-2008).

<sup>7</sup> Fortunately, 10b-5 has been interpreted very broadly by SEC and by courts such that it captures Enron/Worldcom-style frauds.

<sup>8</sup> See Thomas Lee Hazen, *The Jurisprudence of SEC Rule 10b-5* (2005), available at [http://files.alexandria.org/thumbs/datastorage/skoobesruoc/pdf/CI001-ch36\\_thumb.pdf](http://files.alexandria.org/thumbs/datastorage/skoobesruoc/pdf/CI001-ch36_thumb.pdf).

### Moral #3: Share it with your brothers<sup>9</sup>.

Investor protection policy should not be limited to the regulatory prohibition of bad behaviors of corporate managers. Besides forbidding and penalizing ‘sinful’ acts, the government should also encourage a meritorious and desirable actions via positive and principled policies. For instance, imagine that Congress passes ‘Tax Simplification Act’ that eliminates double taxation on corporate dividends. Then, corporates will be more willing to pay out dividends and investors will be more willing to invest in and hold on to stocks. How does this protect stockholders? To answer that question, we should first examine how stocks harm investors in the current regime of double taxation on dividends.

There two kinds of security: debt and equity. A debt, such as bonds, is an investment with interests and payback of the principal. In contrast, an equity, such as stocks, is an ownership interest with no guaranteed dividend or sell-back of the initial investment. If you buy a share in Apple, Apple has no obligation to issue you a dividend, and Apple has no duty to buy back your stock, and it is not guaranteed that you will find someone to buy your stock in secondary markets. It is true that stocks have advantages over bonds in that you are a partial owner of Apple, and so you can vote in elections of board directors. But if you are a retail investor, corporate politics would not interest you. You are interested in return on investment. The advantage of stocks over bonds that interest you, then, is the flexibility that stocks have.

It is true that bond holders can sell bonds to others. But it is easier to sell stocks than bonds<sup>10</sup>. Stocks are more liquid than bonds, i.e., easier to buy and sell, in part because a share of a typical stock involves smaller dollar sum than a bond to buy<sup>11</sup>. Another reason is that stocks yield higher return as they are riskier than bonds. The total money invested in bond market is far larger than that in stock market<sup>12</sup> by roughly two to one. Nonetheless, investor protection regime focus more on stocks than bonds because there are more flexibility in stocks and so more room for frauds. Especially, investor protection focuses on short term investment aspect of stock market, i.e., regarding an investor making money by selling stocks to other investors rather than

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<sup>9</sup> See Luke 6:38 (NIV) (“Give, and it will be given to you. Good measure, pressed down, shaken together, running over, will be put into your lap. For with the measure you use it will be measured back to you.”), available at <https://www.biblegateway.com/passage/?search=Luke+6%3A38&version=NIV>.

<sup>10</sup> Stocks are generally deemed more liquid than bonds. See Judith H. McQuown, *Inc. Yourself: How to Profit by Setting Up Your Own Corporation* 176 (2004), available at <https://books.google.com/books?id=uwUJKiNetiAC&pg=PA176&lpg=PA176&dq=stocks+are+more+liquid+than+bonds&source=bl&ots=DC95M1sl06&sig=2TQoiY3F45GZ6xhSdclEV9uae40&hl=en&sa=X&ei=vtYrVduuK8OjyAO2k4DACA&ved=0CEAQ6AEwCA>.

<sup>11</sup> Bonds are typically sold at a par value of \$1000, while S&P 500 companies’ average stock price is \$67. See Investing Unit 5: Bonds (Jan. 6, 2009) (last visited May 7, 2015, 10:42 AM), <http://www.extension.org/pages/10946/investing-unit-5-bonds#.VUt5bpVFDIU>; Steven Russolillo, *The Average Stock Price Is Expensive; Get Used to It*, *The Wallstreet Journal* (June 5, 2013) (last visited May 7, 2015, 10:45 AM), <http://blogs.wsj.com/moneybeat/2013/06/04/the-average-stock-price-is-expensive-get-used-to-it/>.

<sup>12</sup> The U.S. bond market is worth \$37 trillion, while the U.S. stock market capital is \$21 trillion. See Kay Tang, *Bond Market Size Vs. Stock Market Size* (last visited May 7, 2015, 10:48 AM), <http://finance.zacks.com/bond-market-size-vs-stock-market-size-5863.html>.

by earning dividends by holding on to them. For instance, regulation protects outsider investors from insider investors who try to buy stocks low when the information is limited to insiders, then sell them high when information gets known to outsiders. Another instance is that regulation protects minority investors from majority investors who try to forcibly buy the left-over stocks from minority investors at a bargain price after M&A deal is done. Some scholars argue that investors should be protected from high frequency traders who have superior, perhaps unfairly so, technology than retail investors.

Instead of focusing on the trees and details of fraudulent schemes or questionable practices in short term stock selling, what if Congress change the law so that it encourages investors focus on long term stock holding? One way to encourage long term investment in stocks is to get rid of double taxation on dividends, as mentioned before. If dividend payment is deductible like interest payment on bonds, corporations will be encouraged to pay dividends, and investors are motivated to hold on to their stocks and so long term investment will be encouraged. The other complementary approach would be to make a mandatory sell-back option for stocks in companies with enough cash at hand, say above 10% of its total asset. That is, if a company has grown so much that its cash level exceeds the regulatory threshold under the new law, the company must give stockholders right to sell the stocks back to the company, if the stockholders want to sell them. If enough stockholders sold back to the company so that its cash level falls below 10%, other stockholders should wait until the cash level rises again above 10% of the company's total asset.

The double regulatory regime of dividend deduction and mandatory sell-back option of stocks will make stocks more like bonds. But the principal difference between stocks and bonds will be preserved: dividend payment is a share of profit, while interest payment of bonds is a fixed sum regardless of the growth of the company.

The next question is, what should the price at which mandatory sell back option is exercised? Should it be the IPO price, or the price at which the current stockholder purchased the stock at a secondary market, or the current market price? It should be the original IPO price, as the purpose is to look like a debt's principal repayment. Then the secondary buyer will lose some money after all, even after exercising the option, by the amount of stock appreciation. Even so, that is a bad thing, as the dramatic increase in stock price is the cause of eventual market price. Mandatory buy-back-at-book-value option regime may make secondary stock purchase less attractive, and thus will slow down the price hike in secondary market, removing the illusory portion of stock appreciation. That is, stock price will appreciate only by the amount that the company actually grows. This is a good thing, as the regime gives the secondary stock market a cold reminder that the principal payback is no more than the payback of the money originally owed.

Then there is a practical problem of whether the stock put option will be exercised at all. When the company is doing well, the stock price will be higher than IPO price, so stockholder would rather sell in the secondary market than selling it back to the company at IPO price. When the company is doing bad and stock price is lower than IPO price, stock holder will not be able to exercise the option as the net income of the company is below the put option trigger level.

Then what's the point of instituting a mandatory stock put option that will never be exercised at all?

There are two solutions for this. First, make the mandatory stock put option at IPO price into a call option instead<sup>13</sup>. That is, the call option stock will be repurchased by the company, if it wants to, at IPO price of the stock. The trade-off for the stock holder of such stock would be to make the stock more like a preferred stock in that the stock has dividend payout priority over common stocks. The difference between such call option stock and preferred stock would be that the call option stock is more like common stocks in that its dividend is not fixed coupon rate like that of preferred stock, but based on net income of the company. Second, set the resale price of the mandatory put option stock to the market price of a common stock. That is, the stock holder of the put option stock is entitled to sell the stock back to the company at the market price of the time. The trade-off for the company is to charge a premium for such option to the purchaser of such put option stock. That is, a put option stock will be more expensive than a common stock when they are first sold by the company issuer.

After all the dusts are settled, the next question to ask is, who owns a company when it paid off all its debt and equity? There will be no creditors and no stockholders, so that leaves the company to the employees. A debt/equity-free, i.e., an unencumbered company is likened to a company after management buy-out ("MBO"), a difference being that MBO is done with employees' own money or liability whereas paying off debt/equity is done by the company's own net income. MBO is conceptually superior to merger and acquisition ("M&A"), as M&A typically is a loss to the acquirer matched with a win to the acquired, while MBO enhances performance by increased sense of ownership by employees and boosted morale.

Moral #4: Do not steal<sup>14</sup>.

A continuing debate in economics is the possibility and desirability of indefinite growth of economy<sup>15</sup>. Companies are often reluctant to pay out dividends because the dividend money

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<sup>13</sup> Call options are a common feature in bonds. When interest rate goes down, a bond issuer with call option would exercise his right to repurchase the bond and refinance his business with a cheaper-interest debt. Another way to look at this is, when interest rate goes down, market bond price goes up, and a call-option holder/bond-issure can repurchase the bond at the pre-defined strike price below the market bond price. See Callable Bond (last visited May 7, 2015, 8:22 AM), [http://en.wikipedia.org/wiki/Callable\\_bond](http://en.wikipedia.org/wiki/Callable_bond). Now, let us assume the bond issuer has no call option. When interest rate goes up, market bond price goes down, and a bond-issuer would want to repurchase the bond because doing so would be cheaper than paying back the principal at par value. But the bond-issuer can repurchase only if he has the money to do so, and if the bond holder is agrees to sell the bond back.

<sup>14</sup> See *Exodus* 20:15 (KJV), available at

<https://www.biblegateway.com/passage/?search=Exodus%20&version=KJV>.

<sup>15</sup> One prominent economist said, "Anyone who believes that exponential growth can go on forever in a finite world is either a madman or an economist." See *Kenneth E. Boulding Quotes* (last visited May 7, 2015, 10:52 AM), [http://www.goodreads.com/author/quotes/132720.Kenneth\\_E\\_Boulding](http://www.goodreads.com/author/quotes/132720.Kenneth_E_Boulding).

would have been spent in investment efforts instead<sup>16</sup>. A company manager may say, “Stockholders, please wait some more on dividends. Let us invest instead. Then our company will grow more, make more money. Then we will pay you dividends. Even if we do not pay then, rest assured: you can always sell your stocks at a higher price, right?” There is a problem with this logic. Let us imagine a company that has zero dividend and zero buy-back policy on stocks. Adam is the first stock purchaser and buy the company’s stock at \$10. The company grows and in a year, the stock price goes up to \$20, and Adam sells it to Ben. The trend of \$10 accretion per year continues to Charlie, Diana, Edward, ..., Xena, Yolanda, and finally, to Zach. Zach buys the stock at \$260, twenty five years after the company’s IPO. During the two and a half decades, the company never paid a dividend, never bought back stocks from shareholders, investors realize now. The company’s stock price plunges to zero and Zack lost \$260. Where did his money go? Each of \$10 went to twenty five predecessor stockholders all the way from Adam, Ben, ..., Xena and Yolanda, and the other \$10 went to the company. Everyone made \$10 at the expense of Zach. What does this remind us of? A Ponzi scheme!

Zero dividend policy yields not only a zero-sum game, but also a Ponzi-like result. If a company fails to pay an investor, the investor has no choice other than recouping the investment by selling to other investors. In other words, a company benefits from Adam but never pays him back, or equivalently, the company ‘steals’ from Adam. Then Adam ‘steals’ from Ben by selling the worthless stock to Ben, the stock whose value is illusory in that it will never pay dividends or never be bought back by the company. The chain of ‘stealing’ continues all the way until Zach buys the stock at a price twenty six times its IPO price. Does this sound too fictional to the reader? It is not. This is precisely what happened in the Great Depression of 1929. Stock market price grows up and up until there is no more capital left in the economy to be invested in stocks.

What is the lesson here? The lesson is that the indefinite growth of a company’s stock price is impossible. The belief of indefinite growth is illusory and if a company’s policy is based on such faulty assumption, the company is bound to crash. If such misguided belief is prevalent in stock market as a whole, the whole system will go down just like in 1929 Black Friday. Of course, investors who jumped in such band wagon will lose it all, like the lemmings running toward a cliff. Those who do not learn from history will repeat the mistakes in history.

Moral #5: Stand on your own feet<sup>17</sup>.

The solution to the problem of investor protection is bigger than SEC regulation and legislation of Congress. If we are to solve the problem once and for all, we need to change the

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<sup>16</sup> See, e.g., Sara Frier, *Facebook Has No Plans for Dividend in Near Term, CFO Says*, Bloomberg Business (May 22, 2014) (last visited May 7, 2015, 10:59 AM), <http://www.bloomberg.com/news/articles/2014-05-22/facebook-has-no-plans-for-dividend-in-near-term-cfo-says>.

<sup>17</sup> See *Stand on Own Two Feet* (last visited May 7, 2015, 11:01 AM), <http://idioms.thefreedictionary.com/stand+on+own+two+feet>.

way we think about investment, and the dominant model of corporate financial structure. The current model of corporate finance is to fund the company production by borrowing money from creditors' bonds and investors' stocks. The model is all fine and even unavoidable when a company starts with little or no self-funding. What the author suggests is this: such model should be only limited as an initial funding, and must recede as the company grows. In other words, a company's goal and direction of growth should be the state where the company has zero debt and zero equity, where the company funds itself completely from the profit it generates. Such self-sufficient company can grow indefinitely, because it funds itself completely. To reach the state of self-sufficiency and financial independence, the company should pay back all debts and equities as it grows, not after it grows enough, as such notion engenders procrastination and perpetuates its debt rollover and the illusion of indefinite borrowing that leads to 'growing broke'<sup>18</sup>. If a company adopts the philosophy of self-sufficiency, investors will get paid as the company grows, and thus, will be protected, every single one of them.

Moral #6: There is no free lunch<sup>19</sup>.

The following proposition probably is the most controversial on in this paper: let investors protect themselves by investing less. If investors do not put money in stock market, they will not lose money in stock market. As truistic and trivial as it may sound, a deeper understanding of the proposition requires a reconsideration of a prevalent and widely accepted model of corporate financing. As mentioned in the previous section, a corporate financing comes from debt and equity, not only at the corporate's initial stage, but also on and on after it reaches substantial growth. What if investors spend money in the products and services of the corporation instead of buying stocks and bonds of that corporation? The corporation will get the money either way. The difference is that cash inflow by sale is more sustainable than cash inflow from selling securities. Investors may hesitate from spending, and would rather invest, perhaps because they are retired and want to make money without working. Idleness, lassitude, an attitude to make a quick and easy money, that is the source of problem on the side of investors. Investors should change their attitude and rethink about money. They should earn money, rather than making money off of money.

Then how can we encourage working rather than investing? One way to achieve that goal is to eliminate the distinction between capital gain (i.e., investment income) and ordinary income (i.e., earned income) in tax law. Currently, long term capital gain is taxed at a substantially lower rate than ordinary income. For example, the profit from selling stocks that

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<sup>18</sup> See *Long-Term Financial Planning and Growth* (last visited May 7, 2015, 11:03 AM), [http://highered.mheducation.com/sites/dl/free/0072439749/36506/rossfund\\_ch04.pdf](http://highered.mheducation.com/sites/dl/free/0072439749/36506/rossfund_ch04.pdf). The expression "growing broke" describes a situation where a company does grow in sale but only with overly increasing debts such that the company's interest and principal obligation exceeds what it can afford from profits.

<sup>19</sup> See *There ain't no such thing as a free lunch* (last visited May 7, 2015, 11:05 AM), [http://en.wikipedia.org/wiki/There\\_ain%27t\\_no\\_such\\_thing\\_as\\_a\\_free\\_lunch](http://en.wikipedia.org/wiki/There_ain%27t_no_such_thing_as_a_free_lunch). A Nobel-prize winning economist Milton Friedman popularized the phrase.

have been held for more than a year is a long term capital gain, while an annual salary is an ordinary income. One rationale to excise lesser tax rate on long term capital gain is to encourage investment of an idle money that would otherwise be sitting on a savings account. With that money invested in a start-up company, for instance, would be more beneficial to national economy. But that rationale is faulty. If that money is sitting on a savings account, the start-up company can go to the bank to borrow money instead of approaching an investor directly.

What is really worse in the differential tax treatment on capital gain and ordinary income is this: such taxation regime discourages working and encourage idling. It is true that an investor in stocks risk losing all the invested money when the market goes down. But that's why they get paid with interests or dividends, for the risk of loss. There is no need to re-reward them with lesser tax rate. Plus, workers does not have a lesser risk in a market downturn, as they may lose jobs. And worst of all, why should a hard working person should be taxed more heavily than a rich person who is not working at all? The differential tax regime of capital gain and ordinary income is inherently inequitable.

If we should not punish the rich just for being rich, we should not award the rich just for being already rich either. Let us compare apple to apple: an idle rich man who makes only investment income, and a hard working rich man who makes only ordinary income. Why should the idle man be taxed less than the diligent man? Is it because the idle man tend to be a retiree that society wants to give a tax break? Doesn't a retiree already getting money from government for all the benefits like social security or Medicare? If we really want to give the retirees even more benefits via lower tax rate, we should do so via special retiree's deduction, not a less investment income tax rate that a rich young man can surreptitiously tap on.

The removal of differential tax rate between capital gain and ordinary income can be achieved by averaging the two rates in each tax bracket. That way, capital gain tax rate will rise and ordinary income rate will fall. This way, people will be encouraged to work. Will it discourage investment? Not if we also institute the removal of double taxation on dividends and the mandatory sell-back option of stocks. What about retiring people? The treasury is running out of social security fund anyways, so let them not retire, or at least raise the retirement age<sup>20</sup>. The trilogy of uniform tax rate, dividend deduction, and mandatory stock put option will solve not only investor protection problem, but also solve the social security problem, will simplify tax codes, and also solve tax evasion problem<sup>21</sup>.

Now, let us examine a more practical problem with the 'no retirement policy.' It is true that for many people, if not all, productivity decreases with age. But such proposition does not

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<sup>20</sup> An important exception should be recognized for military personnel who currently is and should always be entitled to retire after 20 years of service in the U.S. military. Only 2% of population serve in the military anyway and even smaller percentage serve 20 years in military and even such military 'retirees' do not really retire as most of them get non-military jobs after military retirement. Plus, early retirement package of the U.S. military serves as a substantial incentive to our all-voluntary military service system.

<sup>21</sup> A bulk of tax shelter arises from fraudulent characterization of an ordinary income into a capital gain to take advantage of lower tax rate.

have to be true in the future, though it may be true at the present. Society should encourage exercise and healthy diet. A tax regime can help achieve that goal, for instance, via exercise expense tax deduction, and excise tax on sugar and fat. If such encouragement succeeds, people would be productive not only in later ages but also in their middle ages as well and work productivity will lead to national strength of economy too. Plus, if you think about it, it is a huge waste for a person to retire in their sixties and idle their time in a Florida beach house. That person has accumulated the experiences, knowledge, skills and know-hows of half a century. That person should be educating, teaching, supervising the younger generations. How about a very rich person who has all the money in the world? That person should be encouraged to go back to school to learn something new, via 100% later-education expense deduction tax regime. Education on oneself is a more rewarding and productive investment than putting money in someone else's hands<sup>22</sup>.

#### Moral #7: Educate your children<sup>23</sup>.

It is easier to fool the foolish than to fool the wise. And wisdom may come not only from ex-post experiences of mistakes, trials and errors, but also from ex-ante education and preventative lessons. Many high schoolers of today learn economics as an elective course. The author argue that that is not enough to prepare the youngsters for the complexity of the modern economy. What a high school or even middle school should be equipped with is introductory classes about accounting and finance. The level of mathematics in accounting and finance is very elementary arithmetic- addition, subtraction, multiplication, and division. Instead of forcing them to learn calculus or read the arcane Shakespearean English, let them learn about double entry bookkeeping and read Wall Street Journal. By learning the fundamental principles in accounting and finance, they will learn to avoid investment frauds. Even if they do not become investors, they will learn how to account for their individual or household income and expense, better balance budget, and how to finance their private business ventures and projects. Education of accounting and finance in high schools are more relevant and applicable for any students, no matter what they will major in college, and what career paths they will take. Everyone needs money and needs to manage its ins and outs to be financially independent, and successful.

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<sup>22</sup> See *Matthew 6:19-21* (NIV) ("Do not store up for yourselves treasures on earth, where moths and vermin destroy, and where thieves break in and steal. But store up for yourselves treasures in heaven, where moths and vermin do not destroy, and where thieves do not break in and steal. For where your treasure is, there your heart will be also."), available at <https://www.biblegateway.com/passage/?search=matthew+6%3A19-21&version=NIV>.

<sup>23</sup> See *The meaning and origin of the expression: Give a man a fish, and you feed him for a day; show him how to catch fish, and you feed him for a lifetime* (last visited May 7, 2015, 11:07 AM), <http://www.phrases.org.uk/meanings/give-a-man-a-fish.html>.

## Conclusion

In the extreme scenario, if not in the present state already, the secondary stock market may degenerate into a dog-eat-dog under world where everyone calls each other fools and rip-offs. But we can prevent that from happening by resorting and returning back to the time-honored principle: pay back what you owe. If a company is not obligated to pay back a lender by calling him a different name, e.g., a stockholder, the finance market is bound to repeat the cycle of boom and bust to the extent of Great Depression or Great Recession. To avoid that, we should step back and think about what constitutes the foundation of lending and borrowing: isn't it what we call trust and trustworthiness?

Corporations should pay back what they owe<sup>24</sup>. It does not matter whether they call it a debt or equity. And they should not keep paying what they owe with money they borrow from someone else, lest their business becomes that of a Ponzi plot. Amidst all the fancy rocket science of modern financial market, people came to forget the most basic principles of market morality- do not deceive your customer, build trust, and return favors. It is time that we step back and re-familiarize ourselves with traditional mores and learn to apply to capital market and investor protection context.

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<sup>24</sup> The concept of returning gratitude is captured in one of the Ten Commandments, i.e., "Honor thy parents." See Exodus 20:12, available at <https://www.biblegateway.com/passage/?search=Exodus+20%3A12&version=KJV>.

## APPENDIX: Investor Protection via New Tax Regime

### 1. Tax the Rich, Feed the Poor?

According to the federal income tax data, top 5% of American taxpayers paid more than 50% of income taxes in America<sup>25</sup>. This statistics says two things. First, there are a handful of very rich Americans. Second, these people are paying a lot- they are paying for 50% of the IRS revenue, a primary source of government funding. Should we raise tax for these people? Is it democratic to punish someone for their talents and hard-works? Or is it the human emotion of jealousy that pushes for 'tax the rich' advocacy<sup>26</sup>?

A better policy than directly raising the tax rate for the high income bracket is to raise tax indirectly on two grounds. The first is via excise tax on luxury items<sup>27</sup>. The second is by raising investment income tax rate. People with a huge extra money commonly do two things with the money: spend in luxury goods, or make more money off of money by investing it. An investor wanting to make quick and easy money invites a scam artist wanting to make quick and easy money defrauding the investor. What about sophisticated investors who are fraud-proof?

Warren buffet once famously said, 'I pay with less tax rate than my secretary<sup>28</sup>,' which should be due to lower tax rate on investment income. Also, the CEO of Citibank gets annual salary of \$1<sup>29</sup>, and the rest of compensation via investment income. Thus, flat average uniform rate may increase IRS revenue, reasonably assuming that top 5% taxpayers mostly take advantage of the lower investment income rate. What IRS can do, then, is to set up the uniform tax rate more close to 20%, say 25%, instead of 30%. That way, IRS revenue may decrease than now, and ordinary income earners will get tax reduction. More money will be at the hands of people, rather than government, boosting the economy, reinstating IRS revenue or even increasing it in the long run.

This what Reagan administration exemplified by lowering tax rate: trust the people and believe that people know better, and money at people's hands better boost the economy. What happens when money is at government's hands? People will be paid for not working, expecting

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<sup>25</sup> See Kyle Pomerleau, *Summary of Latest Federal Income Tax Data* (Dec. 18, 2013) (last visited May 7, 2015, 11:09 AM), <http://taxfoundation.org/article/summary-latest-federal-income-tax-data>.

<sup>26</sup> See *Exodus* 20:17 (KJV) ("Thou shalt not covet thy neighbour's house, thou shalt not covet thy neighbour's wife, nor his manservant, nor his maidservant, nor his ox, nor his ass, nor any thing that is thy neighbour's."), available at <https://www.biblegateway.com/passage/?search=Exodus+20%3A17&version=KJV>.

<sup>27</sup> See *Luxury Tax* (last visited Apr 27, 2015, 8:30 PM), [http://en.wikipedia.org/wiki/Luxury\\_tax#Luxury\\_tax\\_in\\_the\\_United\\_States](http://en.wikipedia.org/wiki/Luxury_tax#Luxury_tax_in_the_United_States). Congress attempted to tax luxury items in 1991, but repealed the luxury tax law in 1993, except on luxury cars, for the fear that diminished consumption on luxury items would harm manufacture industry of those items.

<sup>28</sup> See Chris Isidore, *Buffett says he's still paying lower tax rate than his secretary*, CNN Money (Mar. 4, 2013) (last visited May 7, 2015), <http://money.cnn.com/2013/03/04/news/economy/buffett-secretary-taxes/index.html>.

<sup>29</sup> See *Ians*, *Citi CEO Pandit sticks to \$1 annual salary* (Nov. 18, 2009) (last visited May 7, 2015, 11:17 AM), <http://ibnlive.in.com/news/citi-ceo-pandit-sticks-to-1-annual-salary/105472-7.html>.

social welfare checks. People will be less encouraged to work, as their hard-earned money is going away to heavy taxes. But if government trust the market by reducing taxes, people will be working harder and there will be more jobs, as more money will be available for investments. So the author proposes that the uniform tax rate should be at 20%, not 30% or not even 25%<sup>30</sup>.

Then what if government is forced to shut down as IRS revenue suddenly decreases? This is where sugar and fat excise tax comes to rescue. IRS can calculate the equilibrium uniform tax rate such that IRS revenue does not change before and after the uniform rate, say, 25%. From there, IRS may gradually lower the uniform rate at the same time IRS gradually increase sugar/fat excise tax rate, so that market has enough time to adjust. Why is excise tax so significant? It is because heart ailment is the number one health problems in America<sup>31</sup>, obesity is its cause, and sugar/fat culinary culture is the culprit<sup>32</sup>. Lung cancer is by far a smaller problem than heart failure, but there has been excise tax on cigarette for a long time by now. So why not sugar/fat? More health problems, more health care cost, more government Medicaid/Medicare expenses, more taxes to fund them. This is the vicious cycle we need to and can stop, by excise taxes on sugar/fat. Americans, obesity is not an American value. It is an American vice.

## 2. Flat Tax Rate for All?

Note that this paper does not propose any changes in progressive tax rate regime. The current progressive tax rate policy can be justified considering the fact that in order to physically survive, a person need a certain amount of money and not more. Let us say the minimum amount of money to survive in America is \$10,000 a year. If the tax rate is 30% flat for everyone (also assume no standard deduction), a person, A, making \$12,000 would feel more impact on his survivability than a person, B, making \$110,000, as only A's after-tax income would go below the survivability line. Then why don't the government lower the flat tax rate of 10% so that A's after-tax income level is still above the survivability line of \$10,000? In order to achieve a flat tax rate so that no one's after-tax income goes below the survivability line, the flat tax rate must be equal to zero! This is a mathematical concept that can be illustrated by a simple example. Take a person, C, making \$10,001 a year. We want to tax C only by \$1. The tax rate 'x' that would make C's after-tax income equal to \$10,000 would be:

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<sup>30</sup> See *Matthew 16:25* (NIV) ("For whoever wants to save their life will lose it, but whoever loses their life for me will find it."), available at <https://www.biblegateway.com/passage/?search=Matthew+16&version=NIV>.

<sup>31</sup> See Centers for Disease Control and Prevention, *Leading Causes of Death* (Feb. 6, 2015) (last visited May 7, 2015, 11:18 AM), <http://www.cdc.gov/nchs/fastats/leading-causes-of-death.htm>. The seventh in the rank is diabetes, another implication from sugar over-consumption.

<sup>32</sup> For the mechanism of sugar and fat to cause obesity, see Craig Freudenrich, *How Fat Cells Work* (last visited May 7, 2015, 11:21 AM), <http://science.howstuffworks.com/life/cellular-microscopic/fat-cell2.htm>. Basically, sugar consumption increases insulin level, which in turn triggers storage of fat in body tissues. It is the body's way of saying, 'there is enough quick energy source, that is, the sugar. So we will save and store fat for later days for usage.' The reader may recall the expression, 'fat cat.' Excess of riches and obesity have a lot in common. The main point of the Appendix is that people should keep on working and consume their money as they earn it in healthy ways, that is, to learn new things, to improve health, and to better themselves.

$$10,001 * x = 1$$

$$x = 1/10,001 \approx 0.$$

But the government cannot function without tax revenue. And flat tax rate that ensures everyone's survivability is zero percent. That is why progressive tax regime is a practically and mathematically unavoidable policy, even though it does look like a policy to punish the rich. Now, let us factor in the standard deduction, which is designed to lessen the problem of taxing the people near survivability line. Taxing A at the flat 30% rate after standard deduction would be taxing \$2000 at 30%. Taxing B the same way would be taxing \$100,000 at 30%. As you can easily see, the same rate does not yield the same 'impact' on A and B, since B is already well above the survivability line and would need extra money only so much. Differing impact felt by A and B is a justification enough for the progressive tax regime: tax more on people who do not need all that extra money.

One last point about standard deduction is that to be an effective policy, a standard deduction amount should be specific to the price index of a locality. For instance, the survivability level of money in Manhattan, NY, is higher than that of Ithaca, NY. It only makes sense that the standard deduction for the two cities should differ. An easy way to calculate a locality-specific standard deduction amount is to look at the rent expense of a one-bedroom apartment. If the average rent fee of such apartment in Ithaca is \$5000 per year, the standard deduction could be three times of that, that is, \$15,000. Would it be too hard to find the data about average rent fee for each city? Then simply make the calculation based on the population size of the city: average rent expense is roughly proportional to the size of a city, as demands drives up the price. For a simple example, we can conceive a two-point regression model based on Ithaca and NYC. Let x-axis be population size of each city and y-axis be average annual 1-bedroom rent expense of each city. Then Ithaca will be (30K, \$5000) and NYC will be (8M, \$50,000). Connect the two points and now we have a regression model, which will find the approximate average rent expense of any city on y-axis, given the city's population size on x-axis, each corresponding to the regression model line.

### 3. Inflation Deduction in the Uniform Tax Rate Regime

One of the reasons that the current tax law allows lower tax rate for investment income is that a significant part of investment is not really an income but a result of inflation. Eliminating lower rate on capital gain entirely, thus, would result in an unfair disadvantage of taxing in investor for the inflation. To remove such problem, the new 'uniform tax rate law' could allow inflation deduction for investors' investment to the extent of their own invested money for the period of investment. But if the investor purchases a property solely with borrowed money, s/he should not get any inflation deduction, because s/he already would have deducted interest payment on the borrowed money, reasonably assuming that interest rate and inflation rate are relatively commensurate.

Here is an example for the inflation deduction.

X pays \$2,000 over two years (year 1 and year 2), borrows \$8,000 from Y, and so purchase a land for \$10,000.

X pays off \$8,000 for eight years (year 3 through year 10).

X then sells the land for \$15,000 in year 11.

Consumer price index for the January of year 1 is 100, year 2 is 110, year 11 is 200.

X paid \$1,000 over year 1. We will regard all of \$1,000 was paid on January 1 of year 1 to simplify the calculation and also to err on the side of generosity. Then, inflation from year 1 to year 11 is 100%. So all of \$1,000 is deductible.

Next, X paid \$1,000 in year 2. Inflation rate from year 2 to year 11 is  $(200-110)/110=9/11=82\%$ . So X can deduct \$820.

X has been deducting interest payment to Y for the \$8,000, and so X do not get inflation deduction for \$8,000. Allowing such deduction would result in double deduction, considering that interest rate and inflation rate are roughly the same.

All in all, out of \$5,000 gain, X can deduct \$1,820. Assume the current capital gain tax rate is 20% and ordinary income tax rate is 40% for X's tax bracket. Under the new tax regime, X pays the uniform tax rate of 30% on \$3,180. Finally there is no need for calculation of compounding interest every year, as inflation rate over 10 years already has factored in the annual compounding effect.