The United States no longer is a capitalist country. It has created a new economic system that appears to be capitalist but no longer performs the functions of capitalism. Capitalism is a system in which wealth is created and sustained by the production of goods and services determined through market supply and demand. A variety of related structures support capitalism, including the institutions of finance, which provide the funds necessary for the production and trade of goods and services.

While capitalism still characterizes a portion of the American economy, it has become subordinated to a new economic order. This economic system is one in which the financial markets exist primarily to serve themselves. In this system, capital is raised for the purpose of creating, selling, and trading securities and derivative securities that do not finance industry but rather trade within markets that exist as an economy unto themselves. At the same time, those markets have profound and adverse effects on the real economy. This new economic system is Financialism.

Much has been written and said on the American-initiated global financial crisis that began in 2007 and continues today. Little of that conversation recognizes the fundamental change in the function and groundwork of American capitalism that caused the crisis. None of the Obama Administration’s efforts to reform the American economy acknowledge this fundamental transformation. All of the proposals currently circulating seem to seek only to reform the regulation of existing markets and financial institutions in a manner that institutionalizes financialism and imposes little if any social or economic responsibility on them. Few question whether financialism is a sound model for the sustainable future of American economic health. Yet financialism threatens to rob the patrimony of future generations for the profit of the present, and damages our national security by forcing us to outsource the production of our most essential goods and services.
I would like to explain financialism and how it grew in slightly more detail. I know that by trying to cover so much ground, I will almost certainly frustrate you by overgeneralizing and, perhaps, leave you with more questions than answers. I will use data where I have it, but apologize that this work is in its relatively early stages and I have much to do.

Financialism is grounded principally in two dangerous ideas, ideas not dangerous in themselves but dangerous in practice. These ideas have helped to provide intellectual support for the shift from capitalism to financialism and lie at its foundation. The first idea grew out of the work of Adam Smith. Smith's theory of the invisible hand was designed to show how economic growth could better be stimulated by free market activity than by the dominant practice of mercantilism, while at the same time pursuing the Enlightenment goal of freeing people from oppressive economic and social policies and providing the opportunity for them to improve their own economic conditions. Smith's theory was as much sociological as political and economic, and was grounded in the behavior of self-interested, but nonetheless morally sensitive, economic man that he had earlier developed in his *A Theory of Moral Sentiments*. Through the nineteenth century, this central idea was transformed by neo-classical economists into a justification for the individual pursuit of maximum utility, and in the twentieth century into the individual pursuit of maximum wealth, all stripped of, and abstracted from, Smith's highly contextualized and social ideas and having all but abandoned Smith's emphasis on real economic growth. The abstraction was complete by the last third of the twentieth century, and free market ideology resulted in the substantial deregulation of the American economy. This cleared the way for the growth of financialism.

The second idea, which depended on the notion of free markets, was the capital asset pricing model. Developed over the course of a decade by economists principally associated with the University of Chicago and the Massachusetts Institute of Technology ("MIT"), the capital asset pricing model reduced stock selection to a single number, beta, which was derived from a regression analysis of a stock price's historical movement in relationship to the market. While the goal of this model was to permit investors rationally to make decisions balancing risk and return, its unintentional consequence was to separate the investment decision from any need to be interested in, or concerned with, the underlying corporation issuing the stock, leading to a separation of stock ownership from the underlying business and laying the groundwork for an irresponsible and detached investor class.
Building upon the capital asset pricing model, option pricing theory developed as a way to bring certainty to the derivatives market, the market for trading in instruments that in part track the behavior of stocks and bonds without requiring a trader to own the underlying security – as Paul Krugman describes them, “claims on claims.” The result was an explosion in over-the-counter derivatives trading and the creation of a bewildering variety of new securities, all of which were further removed from the real economy than even the deracinated portfolios assembled by investors using beta.

The complex economic modeling that produced these theories, combined with new technologies, also led to the possibility and proliferation of computer-based trading and its contemporary realization in high frequency trading, further detaching any human element of concern for the real economy while at the same time profoundly affecting real economic behavior by affecting the underlying stock prices that drive managerial incentives. The combination of these practices with free market ideas and policies that equated responsibility with selfishness laid the groundwork for a capitalism centered on a financial industry and capital markets that had largely lost touch with the fundamental purpose of capitalism as a system for the production of goods and services and wealth creation and distribution. It laid the groundwork for financialism.

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No single factor can describe the development of a complex economic system, but I would like to provide a brief historical account of the creation of financialism from the early 1950s to the present in an attempt to tie together a number of different trends. These trends include a sharp growth in the number of individual investors, the eventual dominance of institutional investors and the rise in institutional activism, changes in investment goals from dividends to capital gains, dramatic increases in market volatility, changes in executive compensation, and the deregulation of financial institutions in a manner that stimulated speculation by commercial banks and led to the creation of financial instruments that bore little relationship to the real economy. These trends had combined by the turn of the twentieth century to create financialism. I will discuss the most important elements arising from this history in a little more detail as we go along.

I begin in 1952. Stockbrokers were languishing in a long, desultory market. In fact one historian describes that era as one in which brokers played baseball on the New York Stock Exchange (“NYSE”) floor using rolled-up and crumpled quotation sheets as bats and balls. But that was also the year the NYSE commissioned a study by the
Brookings Institution to determine the number of Americans who owned stock. The surprising result was 4.2 percent of the population. In response, the NYSE instituted a program, “Own Your Share of American Business,” a program of advertising, marketing, public relations, and educational outreach, which was designed to bring greater numbers of individual investors into the market. But increasing the number of American stockholders was not the NYSE’s only goal. In order for brokers to make money, people not only had to buy stock but to trade it as well. In its 1955 Annual Report, the NYSE complained of low turnover, explaining that this was a consequence of an “investment” market in which investors paid cash for their shares. The Report explicitly discussed the NYSE’s continuing efforts to persuade the Federal Reserve to lower margin requirements to stimulate borrowing for investment, making more money available for individual shareholders to invest and with a consequent expected increase in turnover and volatility (and thus commissions), even as its “Own Your Share” campaign for individual investors preached prudence and caution.

While it took several decades for turnover and volatility to explode, the results of the NYSE campaign were almost immediate. By 1958, individual share ownership had grown from the 6.5 million of 1952 to 12.5 million, almost doubling in four years. This number continued to grow dramatically through the 1960s, so that by 1965, twenty million people, more than ten percent of the population, owned stock. The trend continued through the end of the century, as, by 2001, more than half of American families, directly or indirectly, owned corporate stock.

At the same time appeared a new type of investor, who would have a profound impact on American capitalism. These were the institutional investors. From almost a standing start at the beginning of the decade, by 1958 Business Week was calling institutions the future of the stock market. Twenty-two states had adopted the “prudent man rule” by 1953, allowing fiduciary institutions like pension funds to invest substantial chunks of their assets in common and preferred stocks. The pension funds grew rapidly, increasing in value from $11 billion to $35 billion between 1950 and 1957 alone. The book value of the common stock they owned increased from $812 million in 1951 to $2.9 billion in 1955. And, growing almost as quickly, were the mutual funds, which had almost disappeared after the 1929 Crash and had started to make a very slow comeback in the 1940s. From 1940, when mutual funds barely existed, to 1959, between $7 billion and $8 billion of new money was invested in mutual funds. By 1959, they were adding $4.5 billion in a single year. By 2000, institutional investors owned 61.4 percent of American equities, growing to an astonishing 76.4 percent at the end of 2007. And with this growth has come wor-
Financing concentrations of institutional capital and the financial muscle that goes with it; seventeen of the largest American corporations had sixty percent or more of their stock owned by institutions in 2007, including six that had at least seventy percent institutional ownership.

The next aspect of financialism I would like to explain is the historical development of its principal institutions, commercial and investment banks, and particularly the shift in the nature of their core businesses that marks the transition from capitalism to financialism.

The story begins with the growth of the investment banking industry from the middle of the century, as the NYSE permitted member incorporation in 1953, which allowed firms to take advantage of limited liability and therefore engage in higher risk activities. The story goes on to a key moment in the development of the financial industry, the public offering of stock in investment bank Donaldson, Lufkin, Jenrette in 1970, and the tectonic shift in the industry created by the existence of publicly held investment banks, a shift which dramatically expanded both the (realized) possibility of high leverage for the banks and the concomitant explosion in profits and compensation. The greater financial resources that public offerings brought to the investment banks also allowed them to automate, first their back offices and then, far more importantly, their trading desks. Eventually the major human contact that traders had with stock was their design of computer programs to trade it.

By the end of the twentieth century, the industry had undergone a dramatic shift in business focus. Where once investment banks made their money underwriting securities, arranging deals, and providing financial advice to clients, they now moved to proprietary trading, that is, trading for their own profits, and the development of what are generally referred to as “new financial products,” mortgage backed securities, collateralized debt obligations, other exotic derivatives, proprietary hedge funds, and other financial instruments, some of which are aptly described by Warren Buffett as “weapons of mass destruction.” The development of computerized trading, and especially the recent development of high frequency trading, increased the separation of finance from the real economy. Computers do not care about the companies they trade in; computers do not care about the real economy. And as one former Lehman trader was quoted in the New York Times as saying, the traders who set these programs up and even engaged directly in trading cared about nothing but their next bonuses.

These changes clearly moved the financial industry away from the traditional function of finance as providing funds for productive industry, at the same time that it increased the risk to the nation's
credit supply. The new trading-centered finance employed the beautiful minds of Wall Street to help banks and investment banks sell off risk, while keeping most of the profit. The justification for these practices, echoed by Federal Reserve Board Chairman Ben Bernanke, was that they increased liquidity in the American economy and thus the funds available for financing business. This would have been consistent with capitalism, even if much of the profit of this business shift remained with the banks. But the increased liquidity was more commonly used to continue to finance trading and the sale of new financial products like credit default swaps than for financing real economic production. This behavior is financialism, not capitalism.

Another feature of financialism is the relatively recent acceptance of the existence of financial institutions that are too interconnected to be permitted to fail. While not exclusive to financialism (capitalism has sometimes recognized institutions as too big to fail), financialism embraces the existence of such institutions and at least implicitly pledges the continuing willingness of the American taxpayer to sustain their solvency.

The acceptance of the concept of too big to fail is a consequence of misguided free market ideology. While the term often is acknowledged to have originated in the federal bailout of Continental Illinois Bank and Trust Company in 1984, government bailouts had periodically been a feature of American economic policy, including the Chrysler bailout of 1979 and the rescue of Long Term Capital Management in 1998. But it was not until the substantial deregulation of the financial industry with the passage of the Gramm-Leach-Bliley Act in 1999 that financial concentration really exploded, creating the monster banks that characterized the American financial sector at the beginning of the twenty-first century. This transformation, among other things, helped to fuel the rise of trading as a major profit center, not only in the investment banks I have just described, but even in the most traditionally conservative commercial banks. Financial liberation continued with the explicit non-regulation of over-the-counter derivatives by the Commodities Futures Modernization Act of 2000.

American capitalism is not well served by the existence of financial institutions that are too big to fail. A larger amount of somewhat smaller financial institutions that, in a very real economic sense, structurally diversify the risk of economic failure across a broader spectrum of banks and reduce, if not eliminate, the need for continual federal intervention in order to protect the nation's credit supply, is almost certainly better suited both to stimulate production in the real economy and to keep our credit supply safe without unnecessarily chilling appropriate risk-taking.
Financialism has diverted economic resources from capitalist production in the real economy to satisfy the demand of financial claimants, primarily stockholders. Data that I have collected over several years show the disappearance of corporate equity capital and its replacement by massive amounts of debt, largely done to satisfy the demands of finance. The argument here is that American public stockholders have withdrawn more equity from corporations than they contributed, leaving debt as the real risk capital of American industry. Yet the legal power to control American corporations rests with the stockholders. The result is a disconnect between responsibility and risk, and has destabilized the capital structures of American industrial corporations while leaving stockholders with the power to pressure managers to gamble with industrial credit and economic well-being. While stockholders do continue to take risks, the logic of the capital asset pricing model tells us that the risks they take are casino risks created by themselves, not real financial risks which have been left to creditors. What is true of stockholders is even more true of derivatives traders and the financial institutions that largely trade for their own accounts.

Here are some facts: From the turn of the twentieth century until the 1960s, American industrial corporations practiced a policy of retaining substantial portions of their earnings for reinvestment in their businesses while paying a reasonable dividend to shareholders and relying upon trade credit and some long-term debt for the balance of their needs. Retained earnings averaged in the range of fifty percent to sixty percent as recently as the early 1960s. By 2007, that average was down to eleven percent, rising from a low in 2002 of just over three percent. Almost all of the rest of the money needed to finance production came from debt, increasingly shoved off-balance sheet to conceal corporations' true reliance on borrowing.

How and why did this happen? As more Americans entered the market, which grew at its fastest pace during the great bull market that lasted from 1952 until 1970, investors' desires shifted from steady dividends to making quick capital gains from trading. Prior to the 1960s, those capital gains largely came from the increase in share value caused by the retaining earnings I just mentioned. The investment technology derived from the capital asset pricing model taught investors to see capital gains as coming from the future anticipated cash flows of the corporation, discounted to present value. Thus, instead of selling their stock for money already earned, investors began to sell their stock for money that was to be earned but which may never be earned, and effectively stripped the profits of the future for the benefit of the present. This process was exacerbated by the increasing impatience of investors for capital returns, especially the rap-
idly growing class of institutional investors whose money managers were compensated based on the amount of assets they had under management, and who were beginning to acquire the ability to put pressure on managers to increase stock prices. Even without this, the increased volatility of trading for capital gains that had started to soar in the 1980s gave managers strong incentives to maintain high stock prices in order to maintain the independence of their companies, and later to increase their own compensation as stock option compensation came to dominate due to tax reform in 1993. The result was to put pressure on managers to manage for stock price, not for long-term sustainability. Perhaps the most trenchant piece of evidence for this is the fact that in a three year period ending in 2007, the Standard & Poor's 500 spent more money on stock buybacks (which increases stock prices) than on investment in capital production.

I have thus far shown the development of financialism and its effects upon corporate finance. But financialism also profoundly affects the way that managers of businesses in the real economy define their business goals. As of 2007, financial assets constituted almost forty-eight percent of the total assets of non-farm, non-financial corporations. Only a relatively small portion of this is composed of accounts receivable. By far the largest class is identified as “miscellaneous.”

I am still working on data collection, but have done enough to believe that industrial corporations have come to rely upon finance rather than their own core businesses to provide profits, and that this has adverse potential consequences for the future of American economic self-sufficiency.

Why has this occurred? There are several reasons. The first is the capitulation of industry to the demands of finance that I described earlier. The second, which goes along with this, is a shift in the prior careers of industrial Chief Executive Officers (“CEOs”), from marketing and engineering earlier in the century to finance, which came to be the dominant background of CEOs over the last decade. The training and interests of these CEOs, and the greater profits to be made from finance, inevitably incline them in that direction, and suit the demands of financialism better than those of capitalism. American Can Company is a perfect example. Incorporated in 1901, that important manufacturing corporation acquired a modest Midwest insurance company in 1981 and, along with it, Gerald Tsai, Jr., the famous, fallen whiz kid of 1960s speculative mutual funds. As vice-chairman and then chairman of American Can, Tsai abandoned manufacturing and transformed the company into financial conglomerate, Primerica. General Electric, one of the mainstays of American industry since the late nineteenth century, presents a different type of example. While it
continues its manufacturing operations, it now reaps more than half its profits from its financial subsidiaries. It is not difficult to replicate these stories many times over.

A final reason is changes in executive compensation. As compensation soared in the financial industry, CEOs began to compare themselves to their financial counterparts and began to demand increasingly greater amounts of compensation. Even in periods of strong industrial production, the profits of industry often pale in comparison to the profits generated by the new financial economy. In order to earn the returns that would justify higher compensation, they turned to finance themselves.

I have described the growth of institutional investors, but now would like to address the incentives and behavior of institutions that have contributed to the rise of financialism. Institutional investors are a particularly important cause of financialism, even as the Securities and Exchange Commission ("SEC") and Congress are proposing rules and laws that will give greater power over corporate affairs to stockholders which, in practical terms, means institutions. Yet institutional investor activism has been one of the principal causes of destructive short-term management in the real economy.

Institutional activism was hailed in the early 1990s as the solution to the longstanding set of problems known as agency costs caused by the separation in the modern corporation of ownership and control. Agency costs are the losses that result when corporate managers favor their own interests over that of the shareholders together with the expense of preventing this. It was widely thought that institutional investors, through their large blockholdings of stock, could provide the shareholder oversight that disappeared with the creation of the large public corporation at the turn of the twentieth century and had been sought since at least the publication of Adolf A. Berle, Jr. and Gardiner Means's *The Modern Corporation and Private Property* in 1932.

That utopia was not to be realized. Some critics, including me (A Critical Look at Corporate Governance, Vanderbilt Law Review 1992; Corporate Irresponsibility: America's Newest Export (Yale 2001)), predicted that the natural incentives of institutional money managers would lead them to use their power to push corporate managers to focus on short-term stock prices rather than long-term corporate health and patient profits from production. That prediction has been amply borne out both by observation and in rigorous empirical studies, and many of those who had celebrated institutional activism have since retreated from those views.

Two other kinds of institutional investor flourished in the years before the 2008 market collapse and are likely to remain active after
recovery; private equity funds and activist hedge funds. Although very different in their business models and functions, these investors have also contributed to financialism by exacerbating the short-term climate that led to industrial overleveraging, the disappearance of retained earnings, and the practice of subordinating the ends of production for the gains of finance.

Few of the developments I have described could have happened without the triumph of neo-classicism and its effects on American law and public policy from the 1980s through the 2008 collapse.

The legal story begins with a variety of measures designed to deregulate the banking industry, starting with savings and loan institutions in the 1980s and culminating in the virtual liberation of commercial banks from New Deal restrictions with the passage of the Gramm-Leach-Bliley Act in 1999. Banking deregulation began with efforts to permit institutions which had distinctly local or regional business to grow nationally, and increasingly removed restrictions on the businesses in which the regulated institutions could engage. This, along with attractive inducements from states like North Carolina, paved the way for substantial bank consolidation in the 1990s and early twenty-first century.

Traditional small lending institutions thus became further removed from their clients, and banks sought greater profits in the process of securitization, which brought higher profits than mere lending and allowed banks to evade capital restrictions. Securitization, which of course is represented most publicly by mortgage-backed securities and other forms of consumer-debt backed derivatives, allowed loan officers to pay less attention to the safety of their loans, since they were promptly to be sold off and removed from banks’ balance sheets (although not entirely from the risk assumed by the banks). The Commodity Futures Modernization Act of 2000 ensured that these instruments would not be regulated. Despite their profound effect on the real economy, these instruments mushroomed in growth while providing financing not for production but simply for more finance.

This process paralleled what happened in the stock market under the capital asset pricing model and its progeny, largely separating (on paper and in practice) the responsibility for, and consequent monitoring of, risk from the real economy that nonetheless was exposed to that risk. The story of credit derivatives has been told many times, and I only mention it here in order to show how it fits into the rest of the story of financialism, and how the law consciously adopted the ideology of free markets in order to permit financialism to develop.

I would be remiss in ignoring the regulatory failings of the SEC, and especially its fateful decision in 2004 to permit largely unregu-
lated investment banks to dramatically diminish their capital require-
ments (and its inverse, to increase their leverage), eliminating one of
the very few regulatory tools available to the SEC to limit the activi-
ties of investment banks.

In addition, bank regulators, misplacing their trust in the pru-
dence of bankers, also significantly diminished capital reserve re-
quirements. This allowed banks to borrow and gamble with enormous
sums of money while maintaining little available cash to help them
through financial distress. As the United States implemented an in-
ternational agreement to lower banks’ capital requirements in 2007,
New York Senator Charles Schumer said: “There need not be a conflict
between being the safest and the most competitive, and this fine
agreement proves it.” The echoes of economist Irving Fisher’s famous
early October 1929 statement: “Stock prices have reached what looks
like a permanently high plateau,” are all too resounding.

The highlight of deregulation and, I believe, the most foolish piece
of economic legislation ever to be passed by Congress and signed by a
president, is the Gramm-Leach-Bliley Act of 1999. It is most impor-
tant consequence was the merging of commercial banking and invest-
ment banking functions to permit the growth of enormous financial
institutions whose role in protecting the nation’s credit system and
money supply was now compromised by the huge profits available
from speculation in securities and derivatives. This growth was ac-
accompanied by increased incentives of well-compensated bankers to
earn fortunes from engaging in the creation of new financial instru-
ments and proprietary trading which, just as in the years preceding
the Great Depression, exposed that credit system to the possibility of
collapse.

It is unfortunate to note that, despite some recognition of these
failings, the course of “reform” points in the direction of continuing to
institutionalize financialism, which I shall argue will eventually suc-
cceed in destroying American capitalism. At the recent G-20 meeting
in London, Treasury Secretary Geithner’s only real reform agreement
was to increase banks’ capital requirements and explore other regula-
tory measures to prevent future economic collapses. President
Obama’s recent reform suggestions add little to this approach. Such
reforms will do nothing to shift financialism back to capitalism, but
rather maintain financialism on perhaps a slightly safer plane.

Restoring American capitalism in the face of growing financialism
is urgent, both as a function of American economic well-being, and as
a matter of national security, as financialism pushes the production of
essential goods abroad. Faced with this urgency, it is short-sighted
and irresponsible for lawmakers, regulators, financial professionals,
lawyers, and even the investing public, to fail to understand our shift to financialism and the long-term destruction it promises for America’s economic well-being.

How do we fix this? I have some preliminary suggestions I would like to make that I will develop in more detail over the course of my work. It is critical to re-enact laws separating investment banking and commercial banking, pass tax law reform to diminish market volatility, consider financial reform that would require demonstrated economic utility before the offering and sale of new financial instruments, create accounting reform that would require all corporations, including financial institutions, accurately to reflect their debt exposure, ensure full tax parity of capital gains and dividends in order to encourage long-term investment and re-introduce the notion of patient capital into American investment practices, restrict the types of compensation contracts corporations, and especially financial institutions, can award their employees (principally accomplished through tax laws), and create disincentives to proprietary trading and incentives for financial institutions to return to their former financing practices (again, most likely through tax changes). All of these changes could be made without unduly aggressive government restructuring of the basic economy. More aggressive suggestions include the use of antitrust law and perhaps new legislation to encourage the development of smaller and more localized financial institutions that monitor their risk because they remain in relationships with their customers, restrictions on the amount, if any, of a financial institution’s assets it can securitize, and law and policy statements that disavow the acceptance of institutions that are too big to fail, including a reconsideration of the role of the Federal Reserve in financial disasters.

The need to end financialism and restore capitalism is underscored by the special moral role a sound economic system plays in our society. Perhaps the most important benefit of capitalism is its ability to stimulate economic growth, the creation and distribution of wealth, and the sustaining of that wealth over time. Whatever benefits financialism may have, it lacks these essential characteristics. Indeed, as I hope I have at least preliminarily shown, financialism is a system in which the present generation robs future generations of their economic patrimony and national security and thus is intrinsically immoral. We owe to our children, and our children’s children, the benefits of a system that allowed the United States to become the world’s most successful and prosperous democracy from its founding until the present. We must destroy financialism for the sake of capitalism.