

# Finance for the Common Good

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*The Capital Market doesn't get much love these days. It is viewed with suspicion in many quarters, and graduates who take jobs related to finance are described as "selling out." Rather than defending them on their own terms, many seem to think that they are valuable as a means to achieve other—largely unrelated—social goals. This Article, adapted from a pair of lectures in the first quarter of 2024, pushes back against these perceptions. It explains the vital role that the capital market plays in our society and cautions against grafting on secondary objectives. Rather, efforts to regulate the capital market should focus on furthering its primary function so as to promote the common good it already serves.*

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## INTRODUCTION

Law schools are funny places. The stereotypical student comes in wanting to save the world, even if many ultimately sell out and go to large law firms, where their clients consist mostly of large corporations. Some of them—wisely—take corporate or securities law classes before they graduate, perhaps in part to

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prepare for this eventuality. But many who don't (and even some who do) believe that the capital market serves no meaningful social purpose. To the extent that it has any social value at all, the thinking appears to go, it is only to the extent that it can be harnessed to serve some other social goal.

This Article argues that that perception is false. The capital market plays a vital social role all on its own: it connects people with capital to people with ideas, thereby enabling the types of long-term productive investments that enrich every member of society. Along the way, it allows ordinary people to participate in the wealth created when these ideas are made into reality. This is not to say that the capital market is perfect, or that it should not be regulated. To the contrary, effective regulation plays an important role in enabling the capital market to do its job. But the key point is that capital market regulation should be aimed at advancing its primary purpose. Efforts to impose regulations aimed at advancing other goals—however laudable—risk undermining the ability of the capital market to do its job and advance the common good.

The remainder of this Article proceeds as follows. Part I briefly explains what the capital market is. Part II discusses the reasons for, and benefits of, three facets of the capital market: (A) the primary market, (B) the secondary market, and (C) market intermediaries. Part III evaluates the pluses and minuses of the modern American capital market and pushes back against the idea that it should be used to pursue social objectives unrelated to their core function. Part IV then briefly concludes.

## I. WHAT IS THE CAPITAL MARKET?

At its core, finance is about doing two things: transferring value across time and managing risk. The most obvious example of transferring value across time is borrowing and lending. For example, suppose that Adri needs some stuff today. She knows that she'll be able to return it in six months, but she doesn't have it right now. Fortunately, Bill has some spare stuff today, and he doesn't have any immediate use for it. Bill can *lend* the stuff to Adri, and she'll pay it back in the future.

"Stuff" is a term of art here. That "stuff" could be money, but you can't eat money, and it won't keep you warm, and it doesn't do much of anything on its own. People don't have much use for money per se: they care about the stuff that money can buy, and

money is just a convenient way to let people transfer value using different types of stuff that they actually want.

That's the easiest way to think about transferring value across time: Adri wants an apple today; Bill has a spare apple. Bill gives Adri the apple, and she promises to give him an apple back tomorrow, or next week, or next year. Naturally, when the time comes for Adri to return the apple, she's unlikely to give Bill the *exact* apple he lent her. After all, she's probably eaten it, put it in a pie, planted the seeds, or done with it whatever it is that she wanted it for.

This example also demonstrates some of the different reasons people borrow: for consumption (to eat the apple), as an intermediate input into production (to make a pie), or for investment (to plant the seeds).<sup>1</sup> All three of these reasons are important and socially valuable, but let's focus on the third: let's suppose that Adri wants the apple so that she can plant the seeds and grow her own apple trees. So, she says to Bill: "Listen, I don't have any apples right now, but I have this plot of land, some irrigation set up, and whatever else you need to plant an orchard. If you give me an apple today, I'm going to plant the seeds and tend to the plants, and in six years I'll have some apple trees."<sup>2</sup> When that happens, I'll pay you back ten apples."

Notice the alchemy that's going on here: Adri started with no apples. But she made a plan. If she could just get one apple today, in six years, she'd have bushels of apples. So, she gets Bill to lend her an apple, and everything falls into place. Effectively, she's able to transfer one of those apples from the future into the present—a sort of magic trick!

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<sup>1</sup> It has come to my attention that apples do not come "true from seed," which means that if you plant an apple seed, the tree you grow will generally not produce the same variety of apples as the one from which it came. So, while it is certainly possible to grow an apple tree from a seed, most orchards graft a "scion" (the part that will bear fruit) of the desired variety onto a root stock or understock (the part that will become the base of the tree). Maine Forestry, *Grafting Apple Trees*, <https://perma.cc/G2KY-72P4> (last visited Nov. 18, 2024); Emily E. Hoover & Emily Tepe, *Getting to the Root of It: How Rootstocks Influence Apple Trees*, MINN. FRUIT RES. (Oct. 22, 2018), <https://perma.cc/EH9T-UE2L> (last visited Nov. 18, 2024). Notwithstanding this, I have decided to stick with apples rather than, say, potatoes, because while there is a multi-trillion-dollar corporation called Apple Inc., I am aware of no large company called Potato, Corp. I ask the reader's indulgence in setting this complication aside.

<sup>2</sup> Evidently, it takes between five and seven years for an apple tree to mature. Naoko Kotoda, *Flowering and Juvenility in Apple*, in THE APPLE GENOME. COMPENDIUM OF PLANT GENOMES 227, 227 (Samer S. Korban ed., 2021) (describing the cultivated apple's "long juvenile period (5–7 years for seedlings)").

There's also magic on Bill's end. He started with an apple that he didn't particularly want, at least not for the time being. But he knows that he's going to want to have apples in the future—say, six years from now. While apples will keep a long time in a cool, dry place, they won't keep indefinitely, and it's simply not feasible to store a fresh apple for six years. But by lending his spare apple to Adri today, he's able to move it from the present to the future, when he *is* going to want it. And along the way, the number of apples gets multiplied.

The second focus of finance involves managing risk. One way to do that is by dividing up claims. Let's stick with Adri's orchard. Instead of just borrowing one apple today in return for ten apples in six years, Adri and Bill might decide to split the proceeds. For example, maybe they'd agree that Bill will get a quarter of the apples that the orchard produces. By doing this, he shares in the upside, but also in the downside: If it's a bumper crop, Bill's share is bigger; if the harvest is disappointing, Bill's share is smaller.

Another thing they might want to do is pool risk. After all, on average, if you plant some apple seeds and take good care of the plants, down the line you'll get a nice harvest. But the average isn't always that helpful—sometimes you get lucky, and sometimes you get unlucky. So, Adri and Bill might decide to strike a deal with Cathy the chicken farmer down the way. Under the terms of the agreement, Cathy will get a third of the apples harvested from the orchard, and in return, she'll give Adri and Bill a third of her chickens. If it's a great year for apples, Cathy is going to get a great deal, in the sense that she's going to get a lot of apples. But if it's a bad year, Adri and Bill are going to look like the winners—they still get a third of the chickens, even if the apple harvest is lousy. This is diversification. By diversifying across different assets (like apple orchards and chicken farms), everyone involved reduces their overall risk.

And we can even go further. Too much rain is generally not good for apple orchards, and they tend to thrive in warm (although not too hot) summers.<sup>3</sup> Potatoes, in contrast, can tolerate cooler, wetter conditions.<sup>4</sup> So, in a year with heavy spring rains

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<sup>3</sup> Kiersten Rankel, *Optimal Temperature for Your Apple Tree*, GREG (Nov. 8, 2024), <https://perma.cc/6QY4-67S9> (explaining that “[a]pple trees thrive best in a temperature range of 65°F to 80°F”).

<sup>4</sup> Kiersten Rankel, *What Temperature Should My Potato Be Kept At?*, GREG (June 17, 2024), <https://perma.cc/2WMU-PMNY> (describing the “perfect 60-70°F growth range” for potato plants).

and cooler temperatures, potatoes might do well, whereas apple trees could suffer from diseases like apple scab. On the other hand, the apple harvest is likely to be good in a drier, warmer year, while potatoes could struggle with drought conditions. With this in mind, Adri and Bill could make a deal with David the potato farmer: a third of the apple harvest in return for a third of his potatoes. Good years for Adri and Bill are bad years for David, and vice versa. This is hedging.

Once you internalize that *this* is what finance is about—moving value across time and managing risk—it starts to become clear how much social value it can create. Indeed, it's hard to imagine how we could have the modern world without it.

There's one last piece to add to the puzzle: what is the *capital market*? It's just the place where people trade the types of claims discussed above—the claims that allow us to transfer value across time and to manage risk. We can break this down into three facets.

The first is the *primary market*. The primary market is where the people who have ideas (we'll call them entrepreneurs) connect with the people who have resources (we'll call them investors). If an investor likes the entrepreneur's idea, he can invest in her company. She'll take those resources (i.e., the capital) and use them to bring her idea to fruition (or at least, to try to). Some well-known examples of the primary market are investments in startups by venture capitalists and initial public offerings (IPOs). We'll go into more detail about the primary market in Part 0.

The second is the *secondary market*. The secondary market is where a person who's already invested capital can turn around and sell that claim to a third party. The most prominent example of this is the stock market. We'll see how this works, and how it facilitates the primary market, in Part 0.

The final facet is *intermediaries*. There is a dizzying array of different intermediaries in the capital market, but two broad categories get a lot of attention. The first is asset managers. As the name implies, these are entities that manage assets on behalf of someone (or something) else. Asset managers come in many forms, including hedge funds and private equity funds, as well as huge household names like BlackRock and Vanguard. The second category is investment banks, like Goldman Sachs or J.P. Morgan. These entities provide a wide range of services to both companies and investors. We'll return to some examples of what they do in Part II.C.

While the capital market is extraordinary, it doesn't operate in a vacuum. There's a lot of law involved. Obviously, contracts pay an important role, as does civil procedure (after all, the disputes that inevitably arise will have to be resolved), and criminal law (what do we do if someone steals the apples?), along with all sorts of other areas of law. But there are three areas of law that are core to the functioning of the capital market.

The first—and most important—is securities law. Securities law does a lot of things, but its broad purpose is to channel the flow of capital to companies. It tries to do this in a lot of ways, but from a 10,000-foot view, the single most important way that it does so is by governing the flow of information between the company and “the market.” “The market,” of course, is just investors and prospective investors—in other words, people who have resources and have contributed, or are considering contributing, those resources to a project. There are many ways that it does this, the most obvious of which is through mandatory disclosure rules. These rules require certain companies (including large, household names like Apple Inc.) to publicly report specific information at specific times in specific formats.

Two other areas of law play crucial supporting roles: corporate law and bankruptcy law. Broadly speaking, corporate law is interested in the internal workings of corporations. It structures those workings through both default rules and mandatory rules. In particular, a major focus of corporate law is managing agency conflicts between owners (i.e. the investors who own shares in companies) and managers. Bankruptcy law comes in at the back end: its core function is to mediate disputes between competing claimants. Everything in the capital market happens in the shadow of what will happen in the event of bankruptcy.

## II. THE VIRTUES OF THE CAPITAL MARKET

Notwithstanding their many virtues, it is clear to anyone who has been paying attention that finance is something of a dirty word in many circles. Even those who don't view the field with outright hostility often regard it as, at best, an unfortunate fact of life to be tolerated, but certainly not celebrated. This is doubly true for the capital market—to the extent that people think about it at all, the perceptions are largely negative, with common criticisms focusing on the perceived greed, inequality, and inefficiency within these markets. These perceptions, however, miss the forest for the trees. While it isn't perfect (very few things are), the

capital market provides enormous social value. Far from being unfortunate, it is an amazing engine of social value.

#### A. The Primary Market

This social value starts in the primary market. Perhaps the most famous pop culture touchpoints of the primary market are TV shows like *Shark Tank*, where entrepreneurs compete to catch the attention of rich (and occasionally obnoxious) venture capitalists, or movies like *The Wolf of Wall Street* (specifically, the IPO scene led by Jordan Belfort and his firm). Captivating though these representations may be, there is much more to the primary market than entertainment value.

We said before that the primary market is where people who have ideas connect with people who have capital. Suppose, for example, that someone has an idea for an online bookstore that's going to mail books to your house.<sup>5</sup> Or a service that'll match people who have cars and some time on their hands with people who want a ride.<sup>6</sup> Or whatever other crazy idea you can think of. Some of these ideas are silly,<sup>7</sup> others are brilliant. Still others seem pretty dicey when they start, but are proven right with time, luck, a lot of hard work, and, of course, some resources to help them get off the ground.

Providing those resources is an important job. Without it, we would see much less innovation. The reason is simple: if we don't let people who have ideas raise capital from external investors, then only the people who *already have* resources can fund their ideas. In other words, only rich people would be able to start companies. This would be fine if the only people with good ideas were rich to begin with. But to the extent that one thinks that all sorts of people, not just rich people, have good ideas, this seems like a major problem. Not only does it mean that people who aren't already rich won't have an opportunity to turn their ideas into reality, all of the rest of us will also be deprived of the benefit of their ideas. If entrepreneurs can't access external financing, then we're just writing off their good ideas: they simply won't be able

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<sup>5</sup> This is, of course, how Amazon.com started out.

<sup>6</sup> This describes rideshares like Uber and Lyft, among others.

<sup>7</sup> One such idea was Krawlers, a company that was going to sell knee pads for toddlers founded by Adam Neumann, later of WeWork fame. Peter Eavis, *Adam Neumann and the Art of Failing Up*, N.Y. TIMES (Nov. 2, 2019), <https://perma.cc/85LW-LL9G>. This was a very dumb idea, and it didn't take off.

to access the capital that they need to turn those ideas into reality. That would make all of us worse off.

And notice, just like our apple orchard, this is a mutually beneficial trade. The entrepreneur who comes up with the idea gets the resources she needs to bring her idea to life. The investors who put their resources behind the idea are happy: they get to support a project that they believe in (after all, if they didn't believe in the project, they wouldn't have invested). If the project does well, they get to share in the upside; if it does badly, they'll probably be disappointed, but hopefully they did their research (or hired someone else to do that research for them).<sup>8</sup> The people the entrepreneur employs are happy: they have a job that wouldn't have existed otherwise. And finally, the people who buy the product are happy, since they get to benefit from this new idea, whether it be a smartphone, an electric car, or an impossible burger. All of these ideas were brought into being with the help of investors' resources, and all of them make customers better off.

This is such a feel-good it's almost too good to be true. But that's not to say that it's perfect, or that it works this well all by itself. In particular, it had help from law, including from each of the areas mentioned in Part I. The securities laws help by providing antifraud provisions. To state the obvious, it's very bad for Adri to lie to Bill—or mislead him—in connection with his investment in her enterprise. The reason for this is that if she does so, no one will trust her next time around. More importantly, it's not just that no one will trust her, they also won't trust the next person who comes around looking for an investment.

And indeed, the law treats this very seriously: fraud—including omissions and misleading statements—in this context can lead to civil and even criminal liability.<sup>9</sup> The rationale for this is pretty obvious: we want to make sure that people can trust the information that they receive so that they can have confidence in the market. Obviously, this doesn't mean that everyone will always make money. But it does mean that people will (hopefully) go into investments with the information that they need.

Then there's corporate law. At a high level, we said that corporate law structures the internal workings of the corporation,

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<sup>8</sup> See *infra* Part II.C.

<sup>9</sup> The most prominent antifraud provision is Section 10(b) of the Securities Exchange Act of 1934, along with Rule 10b-5 promulgated thereunder. These are often called the "catchall" antifraud provisions. There are also specific antifraud provisions that apply in the primary market, including Section 11 of the Securities Act of 1933.

and in particular manages agency conflicts between shareholders and managers. Given this, it's pretty easy to see that it's providing the scaffolding for these financing arrangements, including questions like: how do shareholders select directors, who in turn select day-to-day managers? What obligations do those directors and managers have to the shareholders? How will decision-making be delegated from the investors through to the line managers? It's easy to see why better managing these conflicts promotes investment: it's just one less thing that investors have to worry about.

Finally, there's bankruptcy law, which mediates disputes between competing claimants. While it's true that those disputes generally only matter when there isn't enough money to go around, it's also true that everything else happens in the shadow of that possibility. Given that, it's easy to see why this area of law is important: it gives us certainty about what's going to happen if things go wrong, and in the event that it does, it facilitates reorganization. By increasing the salvage value of the claims, it also increases the value of the claims on the front end.

## B. The Secondary Market

Then comes the secondary market. This is where people who've already invested their capital with an entrepreneur turn around and sell their claims to a third party. They can do this directly in a bilateral transaction, or they can meet in a centralized place like the stock market. While the stock market is often likened to a casino (and perhaps even a rigged one), this is as misguided as the perception of primary markets.

It's true that what happens in the stock market doesn't directly affect the company. If you go out and buy a share of Apple stock, you're not giving the money to Apple. Instead, you're buying someone else's investment in Apple from that person. The fact that these are side arrangements may contribute to the perception that the stock market doesn't serve any social value. After all, the thinking goes, these people aren't actually building anything; they're just shuffling around claims to existing companies.

The problem with that view is that the primary market won't function very well without a secondary market. To see why, we can return to our orchard, where Bill gave Adri an apple in return for a promise that he would get a quarter of the apples from the trees that she grew from its seeds. The problem comes from the fact that it takes time for the investment to bear fruit (about six

years in this context, we said).<sup>10</sup> What if, two years in, Bill decides that he needs his capital back? There could be any number of reasons for this: Perhaps he's decided to move to Chicago and wants to buy his dream home. Or perhaps he's getting married and wants to plan a honeymoon. Or maybe he discovers a fantastic charity and decides that he wants to contribute as much as he can to it right away.

Unfortunately, at this point, we're four years away from having any apples. While we could cut down the half-grown trees and sell them as applewood chips for someone's smoker, that's unlikely to be the best use of the resource. An alternative would be to tell Bill that he's out of luck, and that he'll just have to wait another four years. Or we could recognize that while the trees aren't producing fruit yet, they're off to a promising start. Maybe there's someone else—let's call her Erica—who is interested in taking over Bill's claim. Erica could buy Bill's claim on the apples in return for something of value (probably money). Bill can then use that for whatever he wants today. In return, in four years when the trees start to produce, Erica will be the one entitled to a quarter of the apples.

This might seem like a hokey example involving apple trees, but the logic is exactly the same if we swap "apple orchard" with "Apple Inc." Bill has invested capital in Apple Inc. He'd like some of that capital back to use for whatever purpose he happens to have. He could ask Apple for his investment back, but that would be extremely disruptive. While one small investor seeking to exit may not be a big deal, it would become very destructive if lots of investors, representing a large portion of the claims, decided to do so all at once. If that were to happen, Apple would have to scramble to raise cash, perhaps by selling assets like intellectual property or dropping its prices on inventory. All of this would hamper the company's long-term prospects.

The fundamental problem is that investments—whether they be orchards or the development of the newest iPhone—often take time to come to fruition. Corporate law has a solution for this problem: corporations (like Apple) are infinitely lived (at least in theory).<sup>11</sup> There is no predetermined end point. This facilitates

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<sup>10</sup> See *supra* note 2 and accompanying text.

<sup>11</sup> See, e.g., 8 Del. C. § 102(b)(5) (stating that unless otherwise provided for in its charter, a Delaware corporation has a perpetual existence). Of course, Apple Inc. is a California corporation, but California law has an analogous provision. Cal. Corp. Code § 200(c).

long-term investments, but it also means that, without a secondary market, there is no natural time at which investors can expect to receive their capital back. While we could change this, it's pretty obvious why it would be a bad idea. For example, we could have a new regime under which all corporations that are formed will exist for some fixed amount of time (say, five years). When the time is up, the company liquidates and returns the capital to investors. At that point, they could turn around and form Apple 2, Inc., and raise capital for another five years, and so on and so forth.

Obviously, this is a terrible compromise. It would be extremely disruptive for Apple, and it doesn't even do much to help Bill (after all, his capital is still locked up for five years). Unfortunately, it's just not feasible to come up with a time period that's short enough to be convenient for investors but long enough to be useful to the company. Instead, it makes much more sense for Bill to simply sell his claim to Erica. Not only does this suit Bill (and for that matter, Erica), it also facilitates the primary market. After all, Bill and other investors are more willing to invest in the primary market up front if they know that they'll be able to sell their claims in the secondary market down the line.

There are also collateral benefits from well-functioning secondary markets. The most important of these is probably *price discovery*: the fact that market participants can freely trade in these securities means that the prices should reflect the consensus value of the asset at any time.<sup>12</sup> This, in turn, can help enable promising companies to raise additional capital to continue to grow. After all, if news gets out that a company just came up with an exciting new product, its share price should rise. The company can then take advantage of that higher share price to issue new equity (called a seasoned equity offering) at a higher valuation. Or alternatively, it might be easier for it to borrow, since the new

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<sup>12</sup> It's easy to overstate this claim. The strong version of this idea—known as fundamental efficiency, holds that all prices at all times reflect the “true” value of the underlying asset. This is almost certainly not true, which is obvious to even a casual observer of financial markets. For a discussion of the distinction between fundamental and informational efficiency, see Ronald J. Gilson & Reinier Kraakman, *Market Efficiency After the Financial Crisis: It's Still a Matter of Information Costs*, 100 VA. L. REV. 313 (2014). While there's some disagreement about just how “efficient” the capital market is, the consensus view is that, at least when it comes to listed equities, the market is reasonably good at incorporating information in a rational way fairly promptly.

borrowing will be a smaller fraction of the company's total value. Either way, the company will find it easier to raise capital.<sup>13</sup>

If the primary market needed a little help from law, the secondary market needs all that and more. Some of the greatest hits include the regulation of exchanges, including the New York Stock Exchange (NYSE) and the NASDAQ.<sup>14</sup> In fact, we have an unusual double regulation structure: the SEC regulates exchanges, and the exchanges regulate the companies that are listed.<sup>15</sup> So, for example, Apple is listed on the NASDAQ.<sup>16</sup> This means that it has to follow the NASDAQ's rules or it'll get kicked off the exchange, but NASDAQ can't change *its* rules without approval from the SEC.

We also regulate the individuals that facilitate trades, known as brokers and dealers.<sup>17</sup> This includes platforms like Robinhood and Schwab (among many others), as well as the more high-touch (or "prime") brokers that hedge funds use. We have a hugely elaborate regulatory apparatus for these players, which includes managing concerns about conflicts of interest and order execution.<sup>18</sup>

And we can't forget about our antifraud and disclosure rules. The standard antifraud rules we discussed in the context of the primary market discussed in Part 0 still apply,<sup>19</sup> as do the mandatory disclosure rules mentioned in Part 0. This means that public companies (i.e., companies that are listed on one of the

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<sup>13</sup> Of course, the converse is also true: companies that are not performing well will see their share prices decline, making it harder for them to access capital. While this is very likely to be disappointing for the people behind the company, making sure that resources aren't directed into unproductive uses means that they will be available for more productive uses. As a result, this too is also an important part of fostering economic growth.

<sup>14</sup> The core statutory provisions underlying this regulation are Sections 5 and 6 of the Securities Exchange Act of 1934.

<sup>15</sup> The core statutory provision underlying this is Section 19 of the Securities Exchange Act of 1934. For an in-depth discussion (and critique) of the dual regulatory regime, see William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1 (2013).

<sup>16</sup> Apple Inc., Annual Report 1 (Form 10-K) (Nov. 1, 2024), available at <https://perma.cc/4CUV-YNXN> (indicating that its common stock is listed on the Nasdaq Stock Market LLC).

<sup>17</sup> The core statutory provision underlying this regulation is Section 5 of the Securities Exchange Act of 1934.

<sup>18</sup> For an introduction to the regulation of broker-dealers, see THOMAS LEE HAZEN, *BROKER-DEALER REGULATION IN A NUTSHELL* (4th ed. 2021).

<sup>19</sup> *Supra* note 9 and accompanying text. To be precise, the catchall antifraud provisions still apply, while the antifraud provisions in the Securities Act do not necessarily apply.

exchanges discussed above, and/or raise money from everyday investors) also have to make ongoing disclosures about important developments. This gives investors confidence that they're being kept in the loop.

Another thing to note is that these antifraud rules don't just apply to companies and their managers. While those are often the parties with the strongest incentive to mislead investors (or potential investors), the catchall antifraud provisions apply to anyone who makes a material misstatement or omission in connection with the purchase or sale of a security.

### C. Market Intermediaries

Finally, what about financial intermediaries? After all, even if the primary and secondary markets themselves are serving valuable social functions, the intermediaries in these markets could still be cartoon villains.

There are too many types of capital market intermediaries to discuss them all, so let's focus on two broad categories: asset managers and investment banks. The first group includes private funds (like hedge funds and private equity funds) as well as entities like BlackRock, Vanguard, and Fidelity that sponsor well-known mutual funds. The second—potentially even maligned—of investment banks. This includes the much-despised J.P. Morgan, and the even more reviled Goldman Sachs. The entities in both groups have been the target of withering criticisms. BlackRock, for example, has been condemned both for being too focused on climate change,<sup>20</sup> and for being insufficiently committed to that goal.<sup>21</sup> Criticisms of Goldman Sachs have been even more vociferous, including, most memorably, when it was called a “great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money.”<sup>22</sup>

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<sup>20</sup> See *Letter from Ken Paxton, Tex. Att'y Gen., to Laurence Fink, Chairman & CEO, BlackRock, Inc.* (Aug. 4, 2022), <https://perma.cc/PT7R-YQL5>.

<sup>21</sup> For example, the New York City Comptroller vocally criticized BlackRock (among others) for withdrawing from Climate Action 100+ and singling out BlackRock for “[taking] a step even further in the wrong direction” and “caving to climate deniers.” *Statement from NYC Comptroller Lander on Unacceptable Climate Pullback by BlackRock, JPMorgan Asset Management, State Street Global Advisors*, OFF. OF THE NEW YORK CITY COMPTROLLER (June 14, 2023), <https://perma.cc/7K52-NC9A>.

<sup>22</sup> Matt Taibbi, *The Great American Bubble Machine*, ROLLING STONE (Apr. 5, 2010), <https://perma.cc/5V2G-V7T8>.

While they are certainly not running charities, the hostility to these two groups of intermediaries is misplaced. Rather than running amok or siphoning off resources from the real economy, both are solving real problems and helping to make both the primary and secondary markets work better.

Let's start with the perspective of an entrepreneur. Entrepreneurs spend all day every day running their companies and are experts in their business. But they're generally novices when it comes to the capital market, since they very rarely seek to raise capital from investors.<sup>23</sup> Given that, it makes sense for entrepreneurs to hire experts to help them interface with the capital market. The most obvious example of this is underwriting, or selling securities to investors. Underwriting is one of the primary businesses of a large investment bank like J.P. Morgan and Goldman Sachs. After all, most entrepreneurs don't know how to find potential investors, and most investors don't know how to find entrepreneurs looking to raise capital. Underwriters act as matchmakers in the primary market.

Investment banks continue to act as matchmakers in the secondary market through their role as market makers. While many securities trade on exchanges, there are many more that don't. How is a prospective seller of such a security to find a prospective buyer? The answer is a market maker: an intermediary that stands ready to buy and sell at a posted price. Just as the presence of a secondary market facilitates the primary market, prospective buyers who expect to be able to rely on market makers to sell their investments in the future are, in turn, more willing to take the plunge upfront and invest.

Having a matchmaker isn't enough if you don't know what you want to buy. And one obvious challenge when it comes to financial markets is that most regular people (whether they be middle class or wealthy) have absolutely no idea how to identify a promising investment. While some fraction of the public could probably figure it out with enough time and resources, it's probably not efficient for them to do so. After all, people have day jobs, families, and lives outside of work. Some people might enjoy hunting down investment opportunities, but most would be better served by hiring someone else to do it for them (just as they might be better off, say, hiring someone else to fix their car or cut their

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<sup>23</sup> With very few exceptions, a company will go public only once in its life. Even the most prolific serial entrepreneur is unlikely to take more than a couple of companies public.

hair). This is, in a nutshell, what financial advisers and asset managers (collectively, “money managers”) do. And since it’s often very difficult to tell whether an investment is a good one, at least in the short or median term, it might make good sense to use incentive-based compensation to ensure that the money manager does a good job. This is, more or less, the business model used by private funds like hedge funds and private equity funds.<sup>24</sup>

Even if an investor is willing to put in the work to find a good investment opportunity on her own, finding *one* such opportunity isn’t going to be good enough. Even under the best of circumstances, it’s very risky to put all your eggs in one basket. That’s why all modern investing is based on the idea of diversification: by investing in lots of different projects, investors can average out a lot of the risk associated with any one investment.<sup>25</sup> Unfortunately, doing this properly is time consuming. For most people, it would be impossible—or at the very least, impractical—to take advantage of the benefits of diversification using a DIY investing approach. Instead, the overwhelming majority of middle-class investors are far better off investing through mutual funds, especially the types of low-fee index funds and ETFs that the giants like BlackRock and Vanguard specialize in. These have been an enormous breakthrough and vastly improve the wellbeing of households across the country.

Indeed, it’s ordinary households that are the primary beneficiaries of these types of products. Very wealthy individuals and institutions can afford to hire professional managers and spread the cost over a very large portfolio, and very sophisticated investors can probably figure out how to approximate something like a low-fee index fund on their own (although query whether they would want to). But less sophisticated people, with less capital to invest, are not in a position to do either of these things. And given the opportunity to share in the wealth created by the innovation that the capital market creates, making it easier for ordinary people to participate is one more way that the capital market serves the common good.

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<sup>24</sup> The traditional “two and twenty” fee structure (2% of assets under management and 20% of performance above some benchmark) is one well-known example of this.

<sup>25</sup> Modern Portfolio Theory, which dates to the 1950s, is founded on the risk-reduction benefits of diversification. The canonical reference here is Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952). The basic insight is that diversification can lower the risk of a portfolio without lowering its return.

To be sure, the importance of these intermediaries for both the functioning of the capital market and the wellbeing of ordinary households across the country isn't a reason to let the foxes run the hen house. Fortunately, that's not what we do. While some might argue that more regulation is needed, the current regime is already quite robust. First and foremost, the catchall antifraud rules discussed above continue to apply.<sup>26</sup> And in particular, they apply to all these entities.

When it comes to investment companies (including, most significantly, mutual funds), we have an enormously elaborate regulatory apparatus.<sup>27</sup> This doesn't mean that the status quo is perfect, but considering the trillions of dollars that flow through it,<sup>28</sup> the system works amazingly well.

We also regulate investment advisers (i.e., the people who give advice about securities for compensation).<sup>29</sup> They are subject to fiduciary duties, the highest standard of conduct that exists in our legal system.<sup>30</sup> In short, they are legally obligated to act in the best interest of their clients and cannot put their own interests ahead of the interests of their clients.

Finally, we regulate broker-dealers (which include investment banks). When giving advice, broker-dealers are subject to suitability rules. When the recipient of that advice is a retail client (i.e., an ordinary person), the standard is best interest, which means that the advice must be in the best interest of the client.<sup>31</sup>

### III. WHY NOT ASK FOR MORE?

At this point, I hope it's clear that the capital market and the intermediaries that operate in that market serve important social goals, and that law plays an integral part in keeping them all on track.

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<sup>26</sup> See *supra* note 9 and accompanying text.

<sup>27</sup> The primary statute here is the Investment Company Act of 1940.

<sup>28</sup> According to the most recent report from the SEC, registered investment companies (i.e., mutual funds, ETFs, and closed end funds) collectively managed just under \$31 trillion as of June 2024. *Registered Investment Company Statistics*, U.S. SEC. & EXCH. COMM'N, DIV. OF INV. MGMT., (Nov. 6, 2024), available at <https://perma.cc/V5MC-SEQ8>.

<sup>29</sup> The primary statute here is the Investment Advisers Act of 1940.

<sup>30</sup> While the Investment Advisers Act doesn't explicitly state that the investment advisers covered by the statute are fiduciaries for their clients, courts have consistently recognized that they are. See Paul Mahoney & Adriana Z. Robertson, *Advisers by Another Name*, 11 HARV. BUS. L. REV. 311, 331 (2021).

<sup>31</sup> The key regulation here is Regulation Best Interest, 17 CFR § 240.15l-1.

### A. Weighing the Good and the Bad

At the same time, the discussion in Part II doesn't mean that the capital market, or the intermediaries that operate within it, is perfect. As with everything else, there are downsides and shortcomings.

For example, it's true that there is a lot of waste inherent in the way that the capital market operates. We've got all these really smart people spending their talent and brain power on this, rather than on curing cancer, solving climate change, creating room temperature superconductors, or whatever else we think is really important. Part of that is due to the simple fact that the payoffs from working in finance are often greater than what one would make in basic science, or many other fields. Another part of it is because there is often a disproportionate payoff from "winning," or being first, in finance. This "winner take all" structure can lead to an inefficient arms race.<sup>32</sup>

Of course, the flip side of this waste is the innovation that the capital market powers. This, after all, is the crux of the story in Parts I and II.A: the capital market connects people who have ideas with people who have resources. That's how good ideas get off the ground. The path to innovation is never straightforward: it almost always involves a lot of apparent waste. This is just part of what goes into creating that innovation.

The second is this concern that the "rich get richer." While it's true that the capital market allows people who aren't already rich to raise capital to bring their ideas to reality, it's still the case that, on the investor side, you need capital to participate. Because of this, the folks with the most capital are the ones who have the most scope to participate, and the very poor are left out.

There's no doubt that it's hard to invest in the capital market with no capital to begin with. But it's simply not true that the capital market only benefits the rich. More than half of households in this country hold equities (i.e. stock), either directly or through their retirement accounts (like 401(k) accounts).<sup>33</sup> This is why former SEC Chair Jay Clayton used to talk about "Mr. &

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<sup>32</sup> For a colorful description of some of this wasteful arms race, see MICHAEL LEWIS, *FLASH BOYS: A WALL STREET REVOLT* (2014).

<sup>33</sup> According to the most recent Survey of Consumer Finances (2022), 58% of U.S. households own equities. *Changes in U.S. Family Finances from 2019 to 2022*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. 19 (Oct. 18, 2023), <https://perma.cc/2KGN-PN7W>.

Mrs. 401(k).”<sup>34</sup> And even more own them indirectly through pension funds in which they are participants. That’s a whole lot of households that are participating in these markets.

It’s also important to keep in mind that intermediation actually promotes inclusion. Entrepreneurs already know who the very rich people are: they don’t need matchmakers because plenty of entrepreneurs would be happy to pitch them ideas. Wealthy individuals also don’t really need an index fund or another broadly diversified mutual fund to make it cheap and easy for them to obtain low-cost diversification: they can use other means to invest their capital. Instead, it’s the middle-class households who really benefit from a well-functioning capital market. And of course, rich entrepreneurs don’t need to raise money through the capital market if they can just fund their own ideas. In other words, while it’s true that wealthier people have more scope for participating in these markets, tens of millions of ordinary Americans can and are also participating. That’s pretty inclusive.

A third concern is about fraud and scams. While there are lots of rules—including the ones already discussed—they aren’t perfect. Investment scams still happen, and investors can be defrauded. This is obviously bad, both for the people involved and for the integrity of the market as a whole.

On the other hand, it’s also the case that trillions of dollars change hands in the capital market with shockingly little misbehavior. When you stop and think about it, it’s sort of amazing that the system works as well as it does. Every day, people just hand over huge amounts of money through digital platforms (like a brokerage account) to brokers, who use it to buy securities (like a share of Apple stock or an ETF tracking the S&P 500) on their behalf. Then those investors get the benefits of that investment, including the right to vote their shares and to receive dividends, and the right to sell later and realize any gains. All of this works nearly seamlessly because of an army of intermediaries working behind the scenes, and only a tiny fraction of this is lost to fraud or scams. While no amount of fraud is defensible, it would be a mistake to let perfection to be the enemy of the good.

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<sup>34</sup> See, e.g., Oversight of the U.S. Securities and Exchange Commission: Hearing Before the S. Comm. on Banking, Hous., & Urb. Affs., (Sep. 26, 2017) (Testimony of Jay Clayton, Chair, U.S. Sec. & Exch. Comm’n), <https://perma.cc/NN6R-FA85>.

## B. Be Careful What You Wish For

In the last few years, there has been a push to ask the capital market to do even more. For example, there have been calls from many quarters to enlist its help in fighting climate change. The European Union has led the charge with this, for example, by pioneering and implementing the concept of “double materiality,” under which covered companies must include in their annual reports both disclosures that are financially material *and* disclosures that are material with respect to sustainability.<sup>35</sup> While calls to “divest” from fossil fuels have been around for many years in the United States, the interest in climate change and other environmentally responsible investing has taken off in the past few years. While the volume has slowed, the total amount of investor capital in American “ESG” funds remains above \$500 billion.<sup>36</sup> U.S. regulators have also become more interested in the subject, most notably with the SEC’s climate rule,<sup>37</sup> but this was far from the only rule in this space.<sup>38</sup> Unlike their European counterparts, U.S. regulators did not explicitly justify these rules as measures to combat climate change; however, there is little doubt that many proponents of these rules have such justifications in the back of their minds.<sup>39</sup>

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<sup>35</sup> Specifically, this is the EU’s Corporate Sustainability Reporting Directive. For a useful explanation of this directive, see Félix E. Mezzanotte, *Corporate Sustainability Reporting: Double Materiality, Impacts, and Legal Risk* 23 J. CORP. L. STU. 633 (2023).

<sup>36</sup> *Investment Company Institute, 2024 Investment Company Fact Book* Fig. 2.12, <https://perma.cc/ZW49-4GSK>.

<sup>37</sup> Securities Act Release No. 33-11275; Securities Exchange Act Release 34-99678. The rule is currently stayed pending litigation, and its future under the second Trump Administration is uncertain.

<sup>38</sup> Two other notable rules from the SEC include a pair of rules related to ESG funds: the ESG Fund Names Rule and the ESG Fund Disclosure Rule. The Department of Labor has also engaged in rulemaking to undo rules promulgated under the first Trump Administration. 29 CFR Part 2550. In its press release announcing the final rule, the Department of Labor expressly noted that the impetus for the rulemaking was that it had concluded that “two rules issued in 2020 during the prior administration unnecessarily restrained plan fiduciaries’ ability to weigh environmental, social and governance factors when choosing investments.” *US Department of Labor Announces Final Rule to Remove Barriers to Considering Environmental, Social, Governance Factors in Plan Investments*, U.S. DEP’T LABOR (Nov. 22, 2022), <https://perma.cc/CB2M-D8TR>.

<sup>39</sup> A simple thought experiment is helpful here. Take, for example, the SEC’s climate rule. Since the rule would only apply to public companies, it is often thought that such a rule will, at the margin, induce private companies to stay private and public companies to “go dark” (i.e., to stop being public, either directly or by being acquired by a company in a jurisdiction that is not subject to such a rule). One can respond to this possibility in two ways. The first is to be unhappy that this is happening, and to look for ways to circumvent it (perhaps it should be extended to private companies above a certain size, or to all

Proponents of diversity and inclusion have also sought to advance their cause through the capital market. Again, European countries were well ahead of the United States in this regard.<sup>40</sup> The first mover in this space was Norway, which was particularly heavy-handed: it imposed a 40% quota and backed it up with the threat of severe penalties, including dissolution of the company.<sup>41</sup>

Advocates in the U.S. have pushed successfully for similar, albeit much more modest, measures seeking to use the capital market to promote women and other historically under-represented groups to the highest levels of corporate America. The NASDAQ's diversity rule,<sup>42</sup> which was approved by a majority vote of the SEC commissioners<sup>43</sup> before being struck down in an *en banc* decision of the Fifth Circuit,<sup>44</sup> is the clearest regulatory example of this.<sup>45</sup> While not a strict quota, the rule would impose a "comply or explain" regime under which companies that do not have a minimum number of diverse directors (which include women, racial minorities, and LGBTQ+ individuals) would be required to explain why they do not.<sup>46</sup> Large institutional investors,

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companies doing business in the U.S.). The second is to be happy—the investors in the U.S. public markets are spared the dangers of this exposure. I submit that anyone who has the second reaction is unlikely to be primarily concerned about investor protection. The same thought experiment applies to the NASDAQ diversity rule.

<sup>40</sup> See Julie C. Suk, *Gender Parity and State Legitimacy: From Public Office to Corporate Boards*, 10 INT'L J. CONST. L. 449, 451 (2012) (listing five European countries (Norway, Spain, Belgium, France, and Italy) that had "passed legislation requiring gender quotas on corporate boards" by 2011).

<sup>41</sup> Mari Teigen, *Gender Quotas for Corporate Boards in Norway* (EUI Dep't L. Research Paper No. 2015/22, 2015), <https://perma.cc/D9NV-476A>. Initial research found that the quotas substantially harmed Norwegian businesses. Kenneth R. Ahern & Amy K. Dittmar, *The Changing of the Boards: The Impact on Firm Valuation of Mandated Female Board Representation*, 127 Q.J. ECON. 137 (2012). For a retrospective study finding mixed results, see Marianne Bertrand, Sandra E. Black, Sissel Jensen & Adriana Lleras-Muney, *Breaking the Glass Ceiling? The Effect of Board Quotas on Female Labour Market Outcomes in Norway*, 86 REV. ECON. STUD. 191 (2019).

<sup>42</sup> NASDAQ-2020-081; SR-NASDAQ-2020-082.

<sup>43</sup> Securities Exchange Act Release No. 34-92590 (August 6, 2021) ("Order"). This is an example of the dual structure discussed in Part II.B. See *supra* note 15 and accompanying text.

<sup>44</sup> All. for Fair Bd. Recruitment v. SEC, 125 F.4th 159 (5th Cir. 2024).

<sup>45</sup> Like the climate rule, there is some uncertainty about the future of the NASDAQ diversity rule under the second Trump administration.

<sup>46</sup> For a sharp critique of the rule, see Jesse M. Fried, *Will NASDAQ's Diversity Rules Harm Investors?* 12 HARV. BUS. L. REV. ONLINE 1 (2021).

which some scholars have likened to quasi regulators,<sup>47</sup> have also played a major role in advancing this cause.<sup>48</sup>

What's wrong with this? After all, if we can advance these important goals, why not do it? The answer is simple and follows from an inexorable fact of life: when you ask an institution, a person, or any other actor to take on an additional goal, it becomes less good at the goal or goals it was pursuing before. The only exception to this is if the institution, person, or actor was *already* promoting the additional goal as a means of furthering its initial objectives. But of course, in that case, the additional mandate is redundant. This is just boring old logic, although it can be formalized mathematically if one is so inclined.<sup>49</sup>

This is not to say that the capital market can never benefit from a focus on socially responsible goals. After all, to the extent that climate change creates material risks and opportunities for companies, a well-functioning market should be attentive to these risks and opportunities. For example, entrepreneurs who are more attuned to these risks and opportunities should be better able to raise capital from outside investors in order to take advantage of their insights. The same goes for diversity considerations: it may well be that companies that are not making the most of their human capital, or risking alienating large groups of consumers, are more likely to run into trouble than those that are. Given these considerations, investors in both the primary and the secondary markets would be wise to steer clear of these companies, or to press for changes in order to reduce the likelihood of trouble down the line.

Of course, to the extent that this is true, the ordinary self-interest of investors should be all we need. To the extent that we want the capital market to further these goals beyond what self-interested entrepreneurs and investors would do on their own (in terms of material risks and business opportunities), that incremental amount is, almost by definition, a distortion of the capital market.

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<sup>47</sup> Dorothy S. Lund, *Asset Managers as Regulators*, 171 U. PA. L. REV. 77 (2023).

<sup>48</sup> State Street's Fearless Girl campaign is perhaps the most famous example of this. For a discussion of this episode, see *id.* at 106–7.

<sup>49</sup> The problem of multitasking is so pervasive that it has its own literature. For a canonical article exploring the challenges inherent in designing incentive schemes in multitask environments (both of whom later won Nobel prizes), see Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991).

What about the fact that many of the interventions—at least in the U.S.—are based on disclosure?<sup>50</sup> After all, it's just information—who can argue with asking companies to provide investors with more information?

Outside of highly unusual circumstances, companies are free to make *voluntary* disclosures, so this is really an issue of whether these disclosures should be mandatory.<sup>51</sup> This is a familiar issue with a familiar solution: we should weigh the benefits to the capital market of mandatory disclosure against the costs of that disclosure mandate and design a system that leads to the best available outcome. While the ideal policy is not always obvious, one thing is plainly true: not all mandatory disclosures further the goals of the capital market. And there is no particular reason to think that a mandatory disclosure rule geared at pursuing social goals is going to serve the capital market. Instead, any benefits are likely to be external. This leaves us right where we were before: with costs and distortions that are a drag on the capital market, which in turn hampers innovation and growth. The fact that this is operating through a disclosure regime changes nothing.

Even the idea that mandatory disclosures might nudge investors towards investment opportunities that serve social goals becomes problematic once we scratch the surface. To the extent that they nudge anyone, it's likely to be the categories of investors most exposed to social and political pressure. Notably, this group probably doesn't include ruthless hedge funds. After all, if these favored investments maximized risk adjusted returns, these financial investors would be doing it already. Instead, it's more likely to influence entities like public pension funds, which are more susceptible to public pressure.<sup>52</sup> This, of course, implies advancing these social goals on the backs of ordinary workers, rather than through specifically tailored government programs (which, incidentally, are financed through a progressive tax system).

None of this is to say that *no* investor would voluntarily sacrifice some financial return (or take on additional risk) in order to

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<sup>50</sup> Indeed, all of the rules discussed in this Part promulgated or approved by SEC are disclosure based. *Supra* notes 37-39 & 41-42 and accompanying text.

<sup>51</sup> For a classic—yet still enormously relevant—discussion of the rationales for mandatory disclosure in the securities laws, see Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984).

<sup>52</sup> For an article exploring conflicts of interest in pension fund voting, including political pressure, see Ying Duan, Yawen Jiao & Kinsun Tam, *Conflict of Interest and Proxy Voting by Institutional Investors*, 70 J. CORP. FIN. 102089 (2021).

further some social goal. While we seem to be past the high-water mark of so-called ESG funds and other financial products, there is still a significant amount of investor capital in these products. But it's hard to see why we need mandatory disclosure for this to work: voluntary disclosure (with the backing of the antifraud regime, of course) could achieve this just as easily. After all, if investors like something, why wouldn't a company want to trumpet it to them?

The upshot of all of this is pretty straightforward. First, let the capital market be a capital market. Investors can (and should) invest their money however they want. Markets can (and do) supply products to facilitate this investor choice. Naturally, this includes socially responsible investments—if that is what investors want to buy with their own money, there is no reason in the world to stop them, and they should be treated just like any other investment.<sup>53</sup> On the other hand, running environmental regulation (or any other social regulation), including subsidies, through the capital market is costly. It imposes costs on both companies and investors and distorts investment decisions, hampering the capital market's ability to do its job. It's much better to just pursue these social goals directly.<sup>54</sup>

#### IV. CONCLUSION

None of this is to say that the capital market is perfect. But it's performing an awfully important role, and it's doing an awfully good job at it. The American capital market is the envy of the world: it enables mind-boggling innovation, which has improved the standard of living for everyone. It also enables broad participation in the wealth created by this innovation. None of this means that there aren't other problems to be solved, like climate change, discrimination, or any number of other things. But there are many other, much more direct, ways of addressing those problems that wouldn't risk disrupting something that's doing a pretty great job of doing something really important. In other

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<sup>53</sup> For two articles developing versions of this argument, see Quinn Curtis, Jill E. Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?* 120 MICHIGAN L. REV. 393 (2021); Jill E. Fisch & Adriana Z. Robertson, *What's in a Name? ESG Mutual Funds and the SEC's Names Rule*, 96 SO. CAL. L. REV. 1417 (2024).

<sup>54</sup> Some proponents of indirect regulation and subsidies through the capital market argue that they can't achieve these goals directly because of "gridlock" or a lack of political will. There are many problems with this argument, not the least of which is that it is deeply undemocratic.

words, don't try to make the capital market serve some kind of social goal. It's already serving the common good just the way it is.