

SEC HISTORICAL SOCIETY

September 19, 2006

Fireside Chat - Behavioral Economics

THERESA GABALDON: Good afternoon and welcome to the final program in the 2006 Fireside Chat series. I'm Theresa Gabaldon, Lyle T. Alverson Professor of Law at The George Washington University Law School, and moderator of the chats this year. The Fireside Chats are the signature online program of the Securities and Exchange Commission Historical Society, a non-profit organization, independent of and separate from the U.S. Securities and Exchange Commission, which preserves and shares SEC and Securities history through its virtual museum at archive at www.sechistorical.org.

The virtual museum available free and worldwide 24/7, offers a growing collection of primary materials including papers, photos, oral histories and these online programs on the impact that the SEC has had on national and international capital markets since its inception.

The SEC Historical Society and the virtual museum receive no federal funding. We're grateful for the sustained support of Pfizer, Inc. as a continuing sponsor of the Fireside Chat series. We're making a bit of history ourselves today in welcoming Professor Donald C. Langevoort, Thomas Aquinas Reynolds Professor of Law at Georgetown Law Center as our panelist. Don launched the Fireside Chats back in 2004 and served as its first moderator. Don, I'm proud to follow in your footsteps.

Our topic today is behavioral economics, looking at the links between psychology and economics and how cognitive and emotional processes influence our rational or irrational economic decisions. As a bit of background, I'll share this quote from the oral histories interview with Matthew Fink, retired President of the Investment Company Institute, which is in the virtual museum. Mr. Fink said, "There is a field developed in the last several years which challenges the pure market folks who say that the market will take care of everything. I'm talking about behavioral economics and that the people don't always behave from the most efficient point of view as argued by the pure market theorists."

Before we begin our discussion I would like to note that the remarks made today are solely those of the speaker and are not representative of the Society. Our speaker cannot give investment or legal advice. Don, welcome back.

DONALD LANGEVOORT: Thank you.

THERESA GABALDON: I suppose it would be best to start with a bit of overview. Could you start us off with some background on just what behavioral economics is?

DONALD LANGEVOORT: Well, as you said in the introduction, behavioral economics is taking psychology -- what we understand about how people think, make judgments and behave -- and working it into economic decisions. So anything that an economist would be interested in and use the standard tools of economics to study, a behavioral economist might say, well I think I may have a better theory about how human beings behave. Psychology teaches us something, and we should change the predictions of human behavior accordingly.

THERESA GABALDON: Is it possible to specify exactly how it is different from traditional economic analysis?

DONALD LANGEVOORT: It is a branch of the field, so it's part of economics. Economics simply tries to predict how human beings or firms behave in market settings and economic exchange relationships. So this is simply saying we can't use the traditional notion that people are rational utility maximizers. Instead we should take into account how real people behave. Psychologists can tell us a lot of about that. And this becomes behavioral economics.

THERESA GABALDON: Can you describe in general terms just how it might be helpful in analyzing issues in the field of securities regulation?

DONALD LANGEVOORT: All over the place, and perhaps one way to think about it -- and the quote you gave from Matt Fink suggests this -- is by comparing it to what it's not. Conventional, orthodox economics, which has such a hold in the study of finance and the study of markets, predicts that people are rational utility maximizers and they will make choices in a very steely-eyed, unemotional, rational fashion. Out of that come all sorts of predictions that are relevant to securities regulation. For example, if you'd give a rational person a disclosure document, the

rational person will probably read it, think about it and take all that information into account in deciding whether to buy shares of stock or invest in a mutual fund. But most of us would say that that misses some of the things we observe in real life about how people buy mutual fund shares or shares of stock. A behaviorist might come along and say, for example, there are problems we know about in human cognitive processing, information overload for example, so that if you give a 40 page document to somebody, even assuming they read it, they will not necessarily be able to process all that information. So maybe psychologists can help us understand what investors look at and what they ignore and at what point they become so overloaded that the quality of their decision-making becomes worse rather than better.

THERESA GABALDON: Does that suggest that in 1933, Congress would have done better to consult the psychologist before it acted?

DONALD LANGEVOORT: Well, yes and no. If you sat down with Louis Brandeis or Ben Cohen or any of the other people who were influential in the formation of the Securities Acts and the SEC, you would find that they were no fools. I suspect they were not strong believers in market efficiency. But the politics of the time were such that a disclosure-oriented form of federal regulation as opposed to merit regulation, as had been so common among the states, was all that was going to work. And if you're going to build a system of disclosure regulation maybe it's not a bad idea to buy into the illusion that people make use of disclosure in purely rational fashion. So I don't know that the drafters would have done anything differently.

THERESA GABALDON: Do you think that there has been occasion to tweak the disclosure system on the basis of the insights that you've described?

DONALD LANGEVOORT: Yes, although it's been slow in coming. Behavioral economics and the study of market behavior using the insights in psychology has been around since the late 1970s. That's when it started flourishing as a field and has grown rapidly since then. The SEC paid less attention to these insights for a long time than it should have. I think many Commission initiatives would have benefited from learning about the state of the art on judgment and decision making. The reasons are partly political and partly institutional. Once you built an agency around the notion that disclosure is good, that disclosure works, then I'm not sure the agency becomes particularly receptive to research and learning that says, well, sometimes it doesn't and that sometimes you have to consider other strategies for the

protection of investors. It challenges the history and the philosophy a little bit too much. But to its credit in the last decade or so, various offices at the Commission have become more interested and have begun to use the insights of behavioral economics. And I suspect over the next few years that influence is going to grow.

THERESA GABALDON: In 2005 the SEC adopted some fairly sweeping reforms of the basic registration system under the '33 Act. Can you see any thumbprint of behavioral economics in those reforms?

DONALD LANGEVOORT: That's not necessarily an area where you can see a very strong thumbprint. Indirectly, sure, in the sense that the system that was put in place in 1933 hardened into a very severe regulatory structure governing what you can say and what you can't say during the period of time before the filing of the registration statement and while you're waiting for SEC comments. The restrictions were all based on the underlying idea we need to wait to make sure potential investors get this thing called the prospectus, so that they can read it and not be influenced by all these other messages flying through the air or being given to them in print. That was probably an unrealistic expectation even back then. In that sense, I think the 2005 reforms are very realistic. They do many things. I suppose the punch line for the offering reform is the notion that "access equals disclosure," that you can put the prospectus on a website, make sure people have access to it, are aware of where it is and that's good enough. My guess is that's pretty consonant with what we know about investor decision making. They may not seek access. Many won't. But many throw away the prospectus too. So I think there is some realism there. But I wouldn't pick it as a shining example of behavioral economics at work.

THERESA GABALDON: It does seem to me that the people who are most likely to read the prospectuses would be the ones who are also more likely to be willing to push the button.

DONALD LANGEVOORT: Exactly. In that sense, I would call the reforms a modern, realistic approach to the public offering process. And what behavioral economics says, more than anything else, is "get real." Don't imagine how people behave. Don't create an idealized sense of how they should behave and assume that they do. Instead, study, research and try to figure out how they actually do behave.

THERESA GABALDON: You've indicated that there has been some progress in academic circles as far as acceptance of behavioral economics and some inroads at the SEC. How about Congress? Do you see behavioral economics kind of it showing up to testify?

DONALD LANGEVOORT: It happened perhaps somewhat dramatically in the aftermath of the various conflict of interest allegations involving the accounting profession -- whether non-audit fees were corrupting the judgment decision of auditors. Some of the initial responses were that it's a classic economics problem, that so long as you take away the financial incentives, take audit firms largely out of the management consulting and other non-audit fee generating business, the conflict disappears and we will get objective and pure advice out of the accountants.

Max Bazerman who teaches at Harvard Business School, and is a very well-known figure in behavioral economics, testified both before the SEC as it was considering rule-making, and if I recall before Congress as well, saying that what we know about conflicts of interest and how they affect judgment and decision making suggests it's a far, far deeper problem, and that merely taking away non-audit fees is not going to solve the problem. People reason in a motivated fashion; so long as control of the audit remains in the hands of management, auditors will consciously or subconsciously adjust their perceptions to be in accord with what management wants. You're going to get biased judgments.

But again let's be politically honest. It is hard to sit in front of Congress or the SEC and make predictions about human behavior that might be very realistic but for which you can't yet put on the table hard-core evidence, proving that we "know" this to be true. One of the problems with behavioral economics and behavioral finance is that it is fairly early in its development. The field is growing. We're starting to learn. We're starting to develop theories of human behavior. But the knowledge isn't solid yet. And so the best for public policy making perspective the behavioral economist can do is say, wait, be cautious here. We're starting to discover some things that suggest your policy will or won't work. We can't tell you for sure. We don't know enough yet. Hopefully as the field develops we will be able to tell you more. But right now, it's the cautionary note that they're most useful for.

THERESA GABALDON: So whereas traditional economics has the baseline assumption of bounded rationality, behavioral economics doesn't necessarily have something to substitute. Is that correct?

DONALD LANGEVOORT: The Holy Grail is finding that substitution and there are behavioral economists staying up 20 hours a day trying to do so. But right now what you realize -- and this is common sense intuition that many non-psychologists, non-economists come up with on our own -- is that human life is so rich and diverse that most judgment decision making is highly contingent. It depends on what's around us. Who is around us? What our mood? There are hundreds of factors that are going to vary from person to person and even within a person from time to time. So making grand predictions like orthodox economics does -- that people maximize utility in a rational fashion -- psychologists will tell that we can never do anything as simple as that. Life is complicated. People are complicated. So we can't give you nice, easy punch lines. But of course, what you hope you can come up with through this kind of research is if not nice, easy punch lines, at least generalizations about behavior in economics settings, what lots of people are likely to do in similar situation that the SEC and Congress can use in formulating rules and regulations.

THERESA GABALDON: It sounds as though there haven't been a tremendous number of empirical studies developed but that people are attempting empirical studies on these matters. Can you describe any of the studies?

DONALD LANGEVOORT: Sure. There are lots of such studies. The problem is they generate results that are not easy to understand or that fit their way nicely into easy predictions. Let me give you one of my favorite studies that I think illustrates both how behavioral economics is done as a discipline, what its potential is and the way it could really translate usefully into policy.

At Carnegie Mellon in Pittsburgh, one of the leading researchers in behavioral economics took a large number of MBA students -- in other words, people who had been out in the business world. One of the criticisms of psychology research is that you have to get subjects into the laboratory. And it's hard to get successful, busy professionals into the laboratory to study them. But MBA students provide as close a substitute as you can get because they've usually had some experience and they have a good bit of training in finance. The researchers basically have them become mutual fund investors over a period of time using computer stimulations to create

changes in the markets. Every few minutes, the person could rebalance the portfolio. And what they were asked to do, the protocol here, was to tell the researchers from time to time on how you've done so far and tell us how you're likely to do with the next set of moves. And of course this can all be carefully monitored.

Most of the subjects thought the main interest of the researchers was knowing how well they were going to do in the future. And that was part of it. Will people be over-confident in their ability to make good mutual fund decisions? Yes, they were over-confident. Their predictions were systematically greater than their actual performance as the computer measured it. The more interesting insight though that was generated by this research was what happened when you ask these people simply to report on how they've already done, which is easily measurable. They had this information very accessibly in front of them. Yet, they systematically overstated how well they'd done. They thought they had done better than they actually had. That's immensely important in understanding how people make investment decisions for retirement savings, for instance. If people don't realize that they haven't done as well as they wanted to do, it's self-deception, it's not admitting to yourself the truth. That's a big baseline in terms of assessing how much good various forms of disclosure or investor education or anything else is likely to do. So that's a nice example of how this research actually plays out.

THERESA GABALDON: It seems to me to be startlingly similar to the results on how people tend to underestimate the number of calories that they consume on a given day.

DONALD LANGEVOORT: Absolutely, it is. A particular interest of mine in research, when I've studied investors, stockbrokers and various others, is the human capacity for self-deception. And yes, we all engage in self-deception. But economists tend to think that stuff disappears in markets where there are real stakes. Markets wash out biases like flattering yourself. A study like this tells us, no, it doesn't. Very unlikely. Many behavioral finance people suggest what the markets do sometimes is amplify biases rather than wash them out.

THERESA GABALDON: Quite fascinating. We had touched on the possible uses of the theories by the SEC and Congress. How about the courts?

DONALD LANGEVOORT: Not directly in the sense that the results of the literature seeming to inform a judge. At least not such that the judge would tell us. You can't find too many judicial

opinions where behavioral finance or behavioral economics is right there. At this stage of the development of behavioral finance and behavioral economics, its main contribution has been to undermine the faith we used to have in efficiency. In the 1970s and 1980s, courts embraced market efficiency rather strongly, the notion that at any time the market price of a stock reflects the rational expectations of intelligent investors. That's one formulation of what's called fundamental efficiency. Lawyers, law professors and many judges thought, that's right, and important things follow from that, such as the fraud on the market theory.

What behavioral finance has said in turn is, not so fast. We're learning things about how markets move, about how they adjust, that lead us to believe that that instantaneous incorporation of all relevant news may not be so flawless. We are seeing in a few cases courts backing off strong efficiency statements. And you have to attribute that to this research that undermines the strong faith in market efficiency. That's been its impact on the judiciary so far. But it's small. And again if you go back to what I said before about this, unlike the neat, easy punch lines of orthodox economics -- that people maximize utility in a rational fashion -- and substitute for the complexity, the richness, the highly situated nature of social judgment and cognition, judges aren't going to be able to use that as easily as they could.

THERESA GABALDON: In your discussion just now you raised the subject of the fraud on the market litigation. Could you follow up on that just a little bit and tell us a little bit more about what that is and about how you as a theoretician might comment.

DONALD LANGEVOORT: Sure. And this is probably example number one of the importance of how both economics and new ways of economic research relate to the securities law. In the 1970s and the 1980s, as belief in market efficiency grew, one of the lessons supposedly taught by that was the notion that all reasonable investors realize they can't beat the market. Thus, don't pay attention to disclosure documents. The professionals are doing that. Disclosure is important but let the professionals, the people who can actually make money in the market, do that. All the rest of us should be doing is relying on the market price as an indicator of the value of the company and expecting normal returns. Just invest in a diversified fashion and that's the best you can do. Now that was a normative statement. That's what we should do. And there's lots of evidence that individuals can't beat the market.

THERESA GABALDON: I'm convinced.

DONALD LANGEVOORT: Very few people would say the evidence is strongly in the other direction. But what academics and courts did is turn that into a legal presumption, that people in fact rely on the market price as an indicator of fair value without thinking further. That insight led to an important rule in securities litigation, that the class of persons who can bring suit for fraud misrepresentation includes not only the people actually relied on the misrepresentation but anybody who bought into the market because we presume all those people were doing the rational smart thing. And so when the Supreme Court in *Basic Inc. versus Levinson* endorsed the fraud on the market theory, it cited the efficient market hypothesis taken from conventional, orthodox economics as the justification for it.

Research since then has said that's not descriptively accurate and it may not even be a good descriptor of the markets themselves. It's not descriptively right in the sense that most investors think they're going to beat the market when they buy and sell stock. When you read mutual fund advertising, the message is that we're very good at stock picking. That's why you pay us management fees. When people invest, and we know this from day trader behavior, they think they can beat the market. As we're learning more and more about how people actually make their decisions, we realize how artificial that assumption was that the Supreme Court bought into.

Secondly, it's not entirely clear – in fact it's highly contestable -- that markets really do instantaneously adjust in a rational fashion to all new information so that it's even something worth assuming to be true. Markets drift, markets overreact, markets correct. Psychology influences the market, which undermines the theory behind the efficient market and behind the fraud on the market theory even more.

So today if you ask the question, should we create a presumption that everyone who bought during the period of the time of fraud is presumed to rely because that's what rational people do, and we can presume that people are rational, you have to say no. Not based on that theory. Now you might justify fraud on the market on deterrence grounds, on grounds that it's the only practical way of case management. You don't want to have individualized reliance assessments -- that would break down the whole system of private securities litigation. And if you think that system has value, the presumption may be worth saving. But not on the theory that the Supreme Court justified it back in the 1980s.

The problem of course is that having justified it in that way, having said this is tied to efficient market thinking, courts came very quickly to the conclusion that that means that the presumption only applies when it's an efficient market. So today many litigators are going into court saying, well, here look at all this behavioral finance, look at all this stuff we know about how the companies' stocks trade. There is no efficiency here. Look at these gyrations that you couldn't explain by anything else. So don't buy into this notion that this class should be certified on fraud on the market grounds. And so courts today are struggling with this theory that the Supreme Court endorsed.

THERESA GABALDON: Somehow this whole subject seems to me to be quite easily related to the subject of irrational exuberance.

DONALD LANGEVOORT: Oh yes.

THERESA GABALDON: And do you think that the existence of what at least some people feel was a documented instance of irrational exuberance have contributed to, on the progress of behavioral economics?

DONALD LANGEVOORT: Sure. If you go back a little bit in the history of behavioral finance, which is behavioral economics taken directly to the world of stocks and bonds, and leave the world of academics and go onto Wall Street and ask, does psychology matter in the markets? The answer is of course. People like David Dreman, a mutual fund money manager, wrote books in 1970s on the psychology of markets. What he would point to, what everybody at the time would point to is, you see bubbles all the time. You see a company whose stock price goes up, not because of fraud necessarily but because investors fall in love with it and then it pops without any fundamental information justifying that radical departure. Aren't bubbles the perfect indication that psychology is right and orthodox economics is wrong?

So that was the going in proposition for many people. Academics resisted that for a long time. But in the early '80s some economists, taking advantage of the psychology literature to some extent, started saying, well maybe bubbles are a real phenomenon. And maybe you can have asset bubbles that are inconsistent with market efficiency, but predictable because we observe them so often. And the study of that -- let's look at particular bubbles, why did they occur, what

do we know about them -- actually generated much of the earliest interest in behavioral finance. So bubble study is associated with the growth of behavioral finance and it has since the beginning.

Irrational exuberance is a phrase from the mid 1990s. Alan Greenspan used it in cautioning investors as the market was on its way up that prices seem to be losing touch with fundamentals. And that was a way of saying, this is psychology, this is animal spirits rather than real. And one of the leaders in behavioral finance, Robert Shiller, who teaches at Yale, wrote a book called Irrational Exuberance basically saying here are the reasons, here is the behavioral economics and behavioral finance that you need to know, to understand that bubbles do happen, that exuberance often is irrational. The conventional economics doesn't explain this stuff all that well.

THERESA GABALDON: Speaking of animal spirits, one of your articles was about using behavioral economics to tame the animal spirits of the stock market. Could you hum a few bars on that on that for us?

DONALD LANGEVOORT: I'm not going to hum anything. First of all, the phrase animal spirits is John Maynard Keynes'. He used it in the 1930s. And if you wanted to do a true history of behavioral economics and behavioral finance, Keynes was very influential. Keynes is famous for saying stock markets are like beautiful baby contests where people aren't guessing what the true value of the stock is. They're guessing what other people will think the true value of stock is, which is an infinite regression, as you try to imagine what everyone is going to say about that subject. It is about predicting human behavior.

So I picked up on that phrase because I think it captured the notion very well and wrote an article about what we've been talking about this afternoon, which is what should securities regulation, what should the SEC and Congress and courts learn from this literature as we know it. My going in proposition -- and I think I was properly cautious on this, going to something I said before, which is that we don't yet have a grand theory of behavioral finance or behavioral economics. You can't make confident, bold predictions about human behavior off of what we have so far. Rather what we ought to do is take what we know from behavioral finance and behavioral economics and see if it helps us understand why things don't work as rationally as the conventional accounts might tell us. And how we might want to tweak regulation or adjust

regulation accordingly. So I looked at a series of issues, the fraud on the market theory being one, where I thought maybe being more psychologically sophisticated could help.

One of the topics I got into, and it's a favorite in the world of behavioral economics, deals with day traders and Internet based fraud. About the time I started writing the article, the SEC brought a fairly well publicized case against Jonathan Lebed, a young teenager in New Jersey, who created postings all around the Internet saying he had found the next stock to double in 36 hours. Here it is. His fingerprints were all over the Net. And it seemed, if you looked at the evidence, that shortly after he would do these postings the price would indeed go up. The SEC also had evidence that Jonathan, being a smart teenager, was investing in these companies, then doing the postings, watching the stock price go up, and unloading very quickly. And then of course because there's no sustained news or information there, within a few hours or a few days, the price would collapse. Jonathan would get rich. Nobody else did. And so when the SEC found out about him, they brought a fraud case against him, classic fraud and manipulation.

And the question that is interesting to struggle with is why did Jonathan's plan work?

THERESA GABALDON: Indeed.

DONALD LANGEVOORT: That was crucial to the fraud case. Because if it's brought as a classic fraud case, the SEC would be required to show that Jonathan made a material misrepresentation of fact, with scienter, in a way that induced the kind of behavior that generated losses for investors.

What did he say that a reasonable investor would likely consider significant? An anonymous posting on the Internet, I know the next stock to double. It strains credulity that anybody would half of an ounce of intelligence would ever take that into account and say, Jonathan is telling me I ought to buy so I guess I will. That's a fool. Had they litigated, Jonathan would've had a perfectly good defense on materiality grounds and doubts about reasonable reliance.

In my article, I set to tell a story about Jonathan and the law that didn't buy into the notion that he made a material misrepresentation that people fell for. We know a lot about Internet day traders, Internet investors. They're not that stupid. They may be overconfident. They may be subject to any number of biases, but actually have greater financial knowledge than the average

investor. I don't know that you could posit that the average day trader, average in and out investor, really believed that Jonathan was making a statement of fact of which they then relied.

My approach is that Jonathan suckered them. Not lied to them, but suckered them. One of the major findings in the behavioral literature is that investors are largely overconfident in their ability to control their circumstances; that, from a lot of study, we know pretty well. And it applies very strongly with respect to online traders.

What Jonathan was really taking advantage of was something like teenagers drag racing. He was basically blowing the whistle, saying let's play a game, let's see who can win this game, get in first and get in out before everybody else does. And if you assume that day traders, the online traders out there, are overconfident in their ability to do that, they'll play that game. But what happens when lots of them decide they play that game even though only a few can win? The price goes up. What happens when they cease doing that? The price collapses. Nobody's been fooled. The only thing that's happened is these traders have clustered around Jonathan as if he's blowing the whistle on a game. He's starting the drag race.

I think that's a better explanation or a more likely explanation for why the price goes up after Jonathan posts these silly little postings. He's just starting a brief game that fools are rushing in to play because they think they can win it, not because they've been deceived.

So I made the point in the article. I thought the SEC was right to bring a case against him. But call it manipulation. From behavioral finance, we can rightly say that any time you intentionally try to use psychological tricks to destabilize the market, to cause a frenzy, where indeed the frenzy ensues, you're doing something that, that the securities laws since 1933 have abhorred -- and that is you are manipulating the market.

So this would be an example of a more psychologically sophisticated look, a real phenomenon of relevance to a real case that the SEC brought where I think when you bring that knowledge to bear you might actually come up with a better understanding of what went on.

There's a debate that goes on among people in this field about what are the regulatory implications of behavioral economics. Do they point to the need for more regulation or less? The answer is they don't point clearly in either direction. They do teach you that some regulation like

disclosure, that we for 75 years have believed really works well, doesn't work as well as we think. On the other hand once we take a more realistic view of behavior, then notions like you've got to police the markets, the markets do need to be fair become more compelling and you need to come up with original strategies for dealing with it.

THERESA GABALDON: So not more or less, but perhaps different.

DONALD LANGEVOORT: Absolutely.

THERESA GABALDON: I think that I've heard something lately about an NASD study of senior citizen fraud that has drawn on behavioral economic insights.

DONALD LANGEVOORT: It's another very good example of using sophistication in psychology to help illuminate important areas in securities regulation. The NASD and AARP have both been interested in fraud on senior citizens, , because when you're living on a fixed income, a fixed portfolio, the impact of fraud is that much more devastating. So to their credit, both have invested in research on why this fraud work. They retained a psychologist at the University of California, Santa Cruz, who did a study looking at actual calls that were discovered during various NASD and SEC investigations of con artists who prey on senior citizens in particular. He basically said, I'm going to take my knowledge of psychology and look at these and I'll tell you why they work and what you ought to target in combating these abuses. The thought was this could of use not so much in NASD enforcement as in NASD investor education. The more we understand about why these pictures work, why these con games work, from a psychological perspective, the better we can do with designing good education programs for investors.

There were lots of different findings that resonate in the psychological literature. The one that I found most intriguing was the following. If you take the group of senior citizens who were victimized by securities fraud and take a control group of senior citizens, similar in all other respects, but who haven't been victimized by fraud and give them a test of basic financial knowledge, what would you discover? Now everyone's prediction would be that the victims were the less sophisticated, less knowledgeable. They found the exact opposite. In fact, the group most easily victimized scored higher on their knowledge of basic financial tools, terms,

techniques than the group that didn't get victimized. That a stunner from the standard rational perspective.

But the psychologist said I'm not all that surprised. In fact to a con artist the person who thinks he or she knows something but don't realize that they don't know enough, is the best mark, the best victim. You can take advantage of people's confidence. Basically what the study says is the best thing you can do to avoid being disadvantaged by fraud is hang up the phone before the pitch starts. People who know they don't know anything about finance tend to do that. They don't want to get into this discussion with some sophisticated, smooth talking person on the other end of the phone. But the people who have some knowledge, some self confidence, say I'll listen. This guy isn't going to trick me. I know too much. And of course that's exactly what the con artist likes. Pick up on various little traits you have, ego, greed and start moving the conversation in a direction so that it starts punching the hot buttons that the person has indicated that he or she has.

Another finding in the study, which relates to some work I've done in other areas is that a surprisingly large number of the victims of fraud have within the last year suffered a negative life event -- a divorce, the death of someone in the family, not one that would necessarily be devastating financially but devastating emotionally. The thought was that person, too, is a pretty easy mark. They believe life owes them something. When the phone rings and they pick it up and somebody is there offering them this special opportunity to get rich really quickly, it subconsciously triggers the thought, "I deserve this." They stay on the phone. And again the skilled con man can take advantage of that.

I thought the NASD study was useful in taking a lot of psychological sophistication and taking it right into the world of securities regulation. Why do cons work? Why do the schemes, the boiler-room operations and things like that, work so easily?

THERESA GABALDON: It does seem to have some very interesting signposts as far as what the shape of investor education might look like. It doesn't seem as though providing people with a starter of financial tools is the way you go.

DONALD LANGEVOORT: No. It may do more harm than good if you offer only rudimentary financial education. You may leave people with the illusion that they actually can protect

themselves, when they can't. A little investment knowledge can be a dangerous thing. There is no doubt that investor education and various strategies that are becoming more and more important to the SEC and the NASD need to take things like this into account.

THERESA GABALDON: It certainly seems as though a “just say no” education strategy with respect to those unsolicited phone calls might be very prudent.

DONALD LANGEVOORT: Sure. And just as prudent, when you're doing investor education, is that you've got to show fraud at work. You can't just say learn to protect yourself. You got to show how insidious it is, how it really does get into the subconscious of people who spend too much time on the phone, who reveal cues that the con artist can take advantage of. That kind of education could be helpful. And you're right. The bottom line for most is, hang up the phone.

THERESA GABALDON: Were there any admissions in those studies that seniors thinking processes were in fact different than anybody else's?

DONALD LANGEVOORT: Not every one is related to being a senior citizen, perhaps with the exception of the negative life event which might be the loss of a spouse, something like that, might be somewhat more predictable as people age. But everything else is just out of the con man's playbook that is being used against a wide variety of the population for a long term.

THERESA GABALDON: I've been focusing mostly on securities regulation and I think properly so, but we have a few minutes in which I'd like to turn to the subject of behavioral economics and its possible implications for the field of corporate governance. Do you have any thoughts or any examples or instances of which you think behavioral economics can gainfully be employed there?

DONALD LANGEVOORT: This is another big field. In corporate governance, the data isn't quite as good as it is with respect to stock prices. And it's harder to study with a high degree of statistical rigor in the governance field. That notwithstanding, let me give you a couple of examples of places where you might take this knowledge and draw important things about corporate governance.

First of all, it is probably fairly well established that to the extent that markets are not efficient, they instead tend to ride in waves. There are booms and busts in the stock market that may reflect investor appetite, investor psychology as much as underlying economic conditions. What you would then guess, for example, is that merger activity, initial public offerings, various financing activity will occur when managers believe that sentiment is on the upswing rather than the downswing. And that has all sorts of implications for policy making with respect to corporate takeovers, mergers, things like that. If what corporate takeovers are about is not disciplining inefficient management but just cherry picking when the market price has been inflated up for your stock or depressed for the targets, then your conclusions about the virtues of corporate takeovers, which is a big issue in corporate governance, change considerably.

There are also places where behavioral economics may start shading into organizational behavior and social psychology. I think we gain a much richer understanding of, for example, independent director behavior or board of director behavior generally if we think of directors not as rational overseers but human beings who are subject to the same kinds of biases and heuristics that the rest of the world is. That they are motivated to see certain things and ignore certain things. That they will treat salient information differently from subtle information. All the things that we learn about how people process information is relevant to the question, how well do we think X will do in monitoring the CEO from the standpoint of corporate governance.

So there's been a big growth in the field of using psychology, using group dynamics to understand boards of directors in ways that I think are more sophisticated than simply treating them as the rational overseers of the company.

THERESA GABALDON: I was wondering if it might also have implications as far as the goals, perceived goals of shareholders are concerned.

DONALD LANGEVOORT: Sure. There's no doubt that in a world where markets are efficient and investors are rational you would expect the stock price to be a rational reflection of value. And if you then said to corporate directors or corporate managers, your job is to maximize share price, it would not be a foolish goal to ask them to pursue.

If instead you say that we can have bubbles. we can have waves in stock prices, that irrational exuberance can take hold in a company like Enron and push its market value up higher than the

fundamentals would have justified, then a rule that says, directors, your job is simply to maximize share price becomes ridiculous. What you're saying is feed the fools.

So share price maximization as a proxy, as our best estimate for what the goal should be, works very nicely in the efficient market world. Behavioral economists would caution against making share price at any given time the be-all and end-all for the normative role of the company as management.

THERESA GABALDON: I thought it might also have implications for perhaps questioning assumptions that all shareholders want from their corporations some monetary return as opposed to clean air and less child labor.

DONALD LANGEVOORT: Right. I don't know that behavioral economics as the field, which is about judgment decision making in economic settings, itself tells us that much about the other preferences that shareholders might have. We've known for a long time that shareholders have a great diversity of preferences in terms of what they want the company to be doing.

Behavioral economics does show that people value fairness to others and those kinds of things strongly in their economic decisions and the evidence is yes. Now you can certainly take that and say that's an indicator that we shouldn't assume that investors are only interested in a buck, especially a short term buck.

So there is promise to take that research. But it doesn't take us all that far.

THERESA GABALDON: We're getting close to the end. I was wondering if you had any articles or books that you might recommend to listeners for basic reading in the field.

DONALD LANGEVOORT: There are two good books by academics on behavioral finance and behavioral economics, relating specifically to stocks and bonds to the world of Securities. One is by Andrei Shleifer at Harvard called Inefficient Markets. Another Robert Shiller, whom I mentioned before at Yale, who's very well known for his book called Irrational Exuberance which is also a very nice treatment of the developments in this field. And I've long been a fan of David Dreman, who deserves a lot of credit for, in the 1970s, sticking to the notion that you can be a contrarian investor, that psychology teaches you to bet against all that so-called smart

money. And he's written a book called [Contrarian Investment Strategies](#) which is to some extent for real investors a bible in integrating psychology into their thinking.

THERESA GABALDON: I knew that you'd be far too modest to mention any of your own writings on the subject. But I would definitely recommend them to our listeners. Don, thank you for this discussion of behavioral economics. It's very illuminating. Thank you also for making possible the successful launch of these series of online programs.

Since 2004, the Fireside Chats have covered wide variety of topics from municipal securities and state securities regulation to online fraud to executive compensation and cross border regulation, all archived in the virtual museum and visited again by our listeners.

I'm going to boast on behalf of Don and myself that our audience today, both live and repeat, is over 8,700 persons. Today's Fireside Chat is now archived in the virtual museum by audiotape. A transcript will be added later.

This is the close of our 2006 series. But we'll be back in spring 2007, I, as moderator, and Pfizer Inc., as sponsor, with a series of discussions on legislation, Congress and the courts as they impact securities regulation.

Please continue to visit www.sechistorical.org for updated information on chats and broadcast dates and times. Thank you again for being with us today.