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Redesigning the SEC: Does the Treasury Have a Better Idea?

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REDESIGNING THE SEC: DOES THE TREASURY HAVE A BETTER IDEA?

John C. Coffee, Jr. and Hillary A. Sale

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INTRODUCTION

SYMPOSIUMS supply a snapshot in time. By observing the common assumptions and shared frameworks of a collection of scholars writing contemporaneously, one gains both insight into the intellectual world of a past era and the ability to measure its distance from our own. Twenty-five years ago the Virginia Law Review organized a noted symposium (the “1984 Symposium”) to

celebrate the 50th anniversary of the SEC.¹ A number of prominent scholars participated,² and its articles have been much cited.

Now, we are at it again; however, there is a difference in the mood. The natural superiority of the U.S. model for securities regulation is no longer an article of faith, and the credibility of the SEC as a financial regulator has never been lower. Commentators around the world attribute an international financial crisis to problems that began in the U.S. housing market and that were exported to the rest of the world by U.S.-based financial intermediaries. This Article will move from an examination of the SEC's responsibility for that crisis to a discussion of how financial regulation should be structured for the future. We do not purport to conduct a detailed review of the SEC's recent performance (and for that we are criticized by one of our commentators).³ In our view, the enduring issue is not the success or failure of the most recent leadership at the SEC, but the comparative advantages of one institutional structure over another. What can an independent SEC do better than alternative regulatory structures—such as the consolidated financial

¹ See *Fifty Years of Securities Regulation: Symposium on Contemporary Problems in Securities Regulation*, 70 Va. L. Rev. 545 (1984). The *Virginia Law Review* earlier memorialized the SEC's "silver" anniversary in 1959. See Louis Loss, *Contemporary Problems in Securities Regulation*, 45 Va. L. Rev. 787 (1959) and accompanying articles, *id.* at 787–1072.

² In alphabetical order, the participants included Professor Alison Grey Anderson, John C. Coffee, Jr., Frank H. Easterbrook, Daniel R. Fischel, Ronald J. Gilson, Edmund W. Kitch, Reinier H. Kraakman, Saul Levmore and Walter Werner. SEC Chairman John S.R. Shad provided the Introduction, and Donald L. Calvin of the New York Stock Exchange also participated.

³ Professor Fisch argues that our analysis is "incomplete." See Jill E. Fisch, *Top Cop or Regulatory Flop?: The SEC at 75*, 95 Va. L. Rev. 785, 788 (2009). In her view, what is most needed at the SEC is "a renewed emphasis on leadership—leadership that entails a commitment to regulation." *Id.* at 821. Leadership is an ineffable quality, more discussed by editorialists and politicians than law professors; nor is it easily measured, and we leave this task to the financial press and media. Yet, as we read Professor Fisch, her primary criticism of the SEC's recent performance is its diminished enforcement effort. We share her concern and agree that there has been a recent shortfall in enforcement. See, e.g., Eric Lichtblau, *Federal Cases of Stock Fraud Drop Sharply: Many Questions About Wall St. Oversight*, N.Y. Times, Dec. 25, 2008, at A1. Still, even if securities fraud cases had been prosecuted more aggressively over recent years, we doubt that this would have saved Bear Stearns, Lehman Brothers, or Merrill Lynch from insolvency. Moreover, underenforcement becomes more likely under some regulatory structures than others. Indeed, we believe that this problem would be aggravated under a consolidated financial regulatory system.

regulator that some have begun to urge?⁴ Our answer is that an independent SEC should be a superior enforcer and more inclined to foster market transparency than a more consolidated regulatory structure would be. Globalization and the institutionalization may have reshaped the markets, but they have not reduced, and may have enhanced, the need for strong enforcement and greater transparency.⁵

A quarter century ago, a debate over regulatory structure would have been unimaginable. To most of the commentators at the 1984 Symposium, the market seemed self-correcting, and they perceived no more than a modest need for regulation. Revealingly, in the 1984 Symposium, scholars said little, if anything, about globalization or technology (indeed, the internet was not then known), but these proved to be among the most dynamic and destabilizing forces that have shaped the intervening era. Nor did scholars focus on comparative law. The U.S. system of securities regulation was implicitly assumed to be the template for the rest of the world to emulate. Finally, securities regulation was not viewed as a part of a broader system of financial regulation, but only as an alternative to state law as a means of influencing corporate governance. Federalism—the allocation of power between state and federal regula-

⁴The Committee on Capital Markets Regulation, which has recently been the leading proponent of further deregulation in securities regulation in the United States, has called for a consolidation of financial regulators through the merger of the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodities Futures Trading Commission into a single body that it would term the United States Financial Services Authority—a name obviously patterned after the U.K.'s body of the same name. See Committee on Capital Markets Regulation, *Recommendations for Reorganizing the U.S. Financial Regulatory Structure* (Jan. 14, 2009) (on file with the *Virginia Law Review*).

⁵We appreciate that others see the increasing institutionalization of the U.S. market as reducing the need for transparency. Professor Langevoort ably voices this theme in his contribution to this Symposium. See Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 *Va. L. Rev.* 1025 (2009). We disagree with at least the stronger assertions of this position (and here agree with Professor Fisch), both because we believe transparency improves corporate governance at the issuer level and because we believe that institutional investors also desire greater transparency and are not as “self-fending” as the proponents of deregulation believe. The Bernard Madoff scandal is only the most recent example that even institutional investors can be defrauded, need public enforcement, and will often fail to contract for necessary protections.

tors—received much attention,⁶ but few focused on the parallel allocation of authority among federal financial regulators. No one asked: why is it that the SEC is an independent agency and not an arm of the Treasury Department or the Federal Reserve? Today, these ignored issues—globalization, technology, comparative institutional structure, and the place of securities regulation within financial regulation generally—dominate the discussion.

What did receive primary attention back then? Above all, the 1984 Symposium demonstrated the new ascendancy of finance theory. The Efficient Capital Market Hypothesis (“ECMH”) was at center stage and the zenith of its acceptance, with a number of authors arguing that it implied that law should play only a secondary and severely constrained role. Others explained that markets worked, less because of law or the threat of liability, but rather because information was produced, collected, verified, and disseminated by “reputational intermediaries”—investment banks, auditors, securities analysts, and credit rating agencies—who pledged their reputational capital behind their opinions and judgments.⁷ Hence, these intermediaries would have little incentive to misrepresent or distort.⁸ For most participants in the 1984 Symposium, deregulation was the appropriate response to this “modern” recogni-

⁶ Professors Anderson and Kitch expressly debated the significance of federalism in defining the SEC’s authority. Compare Alison Grey Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 Va. L. Rev. 813, 856 (1984) (“In the corporate and securities area, the rhetoric of federalism should not be allowed to confuse and obscure discussion of the major substantive policy choices that usually lie behind the invocation of state interests . . .”), with Edmund W. Kitch, *A Federal Vision of the Securities Laws*, 70 Va. L. Rev. 857, 873 (1984) (“As a simple matter of sensible allocation of power and coherent administration, it makes sense to limit national rules to areas such as the securities markets, which are the subject of comprehensive federal legislation, and leave to the states the development of the law governing internal relations with corporations.”). Federalism is, of course, the opium of law professors, which they can rarely avoid, even if there is nothing new to be said.

⁷ See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 604–05, 619–21 (1984). For a fuller development of the theme that certain intermediaries pledge their reputational capital as a bonding strategy and an examination of when and why this strategy often fails, see John C. Coffee, Jr., *Gatekeepers: The Professions and Corporate Governance* 4–10 (2006).

⁸ Thus, a few years later, Judge Frank Easterbrook, a participant in the 1984 Symposium, declared in an opinion that, because auditors would lose more in reputational capital than they could gain in audit fees from a dishonest client, it would be “irrational for any of them to have joined cause with” such a client. See *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990).

tion of the market's efficiency, and, not surprisingly, a major shift towards deregulation was then in progress.

So how much distance separates then from now? Even before the current financial crisis, the bloom was clearly off the rose of finance theory. Intellectual paradigms have shifted over the interim as a new generation of "behavioral economists" has come to view the ECMH more skeptically, emphasizing in particular the limits of arbitrage.⁹ Not only is deregulation no longer the presumptive policy prescription, the sense is growing that deregulation may have deepened the current crisis, which a process of international regulatory arbitrage arguably extended and enforced.¹⁰ Unless constrained by prudential financial regulation, market forces appear to push financial institutions towards excessive use of leverage and inadequate diversification. Similarly, the naiveté behind the view that markets are always quickly self-correcting because of the efforts of reputational intermediaries now seems apparent.¹¹ "Reputational intermediaries" proved to have their own biases and to be highly vulnerable to issuer pressure. Yet, these intermediaries remain indispensable because there are a number of contexts in

⁹ For leading works in this field, all raising challenges to the ECMH, see generally *Advances in Behavioral Finance* 153–65, 167–70 (Richard H. Thaler ed., 1993); Robert J. Shiller, *Market Volatility* 77–79, 431–32 (1991); Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* 10–23 (2000). Of course, many scholars continue to defend the ECMH. See Paul G. Mahoney, *Is There a Cure for "Excessive" Trading?*, 81 Va. L. Rev. 713, 718–21 (1995).

¹⁰ A vigorous debate is in progress over whether firms and financial institutions are migrating away from U.S. markets to less regulated foreign markets (most notably London). Compare Craig Doidge, G. Andrew Karolyi & Rene M. Stulz, *Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices Over Time* 43–44 (European Corporate Governance Inst., Working Paper No. 173/2007, 2007), available at <http://ssrn.com/abstract=982193> (finding New York has held at least even with London as a venue for foreign listings), with Comm. on Capital Mkts. Regulation, *Interim Report* 2–6 (Nov. 30, 2006), http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (finding United States has suffered a decline in competitiveness). Regardless of the empirically correct answer to this question of decline, U.S. policy makers have been bombarded since the passage of the Sarbanes-Oxley Act in 2002 with advice and predictions that stricter regulation will entail a flight by regulated entities to less demanding markets (with London being the usual asserted beneficiary of this flight).

¹¹ Indeed, Professors Gilson and Kraakman, writing in 2003, have conceded their "naiveté" on this point. See Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. Corp. L. 715, 736–37 (2003).

which investors cannot undertake the verification and evaluative tasks that these experts perform.

Today, we term these specialized intermediaries “gatekeepers,”¹² and their repeated failure has dominated public attention. In 2002, Congress responded to the conflicts surrounding auditors, by passing the Sarbanes-Oxley Act, largely to replace private self-regulation of the auditing profession with public regulation.¹³ Also in that year, the major investment banks entered into a Global Settlement with the New York Attorney General, the SEC, and other securities regulators, adopting prophylactic reforms and Chinese Walls to protect the integrity of another gatekeeper, the securities analyst.¹⁴ More recently, the subprime mortgage debacle has demonstrated amply the failure of still another gatekeeper: the credit rating agency.¹⁵ If there is a common theme linking these events, it is probably that self-regulation has severe limitations and seems to work best only when the self-regulator’s duties are clearly demarcated and it is in turn subject to close regulatory oversight.

Viewed panoramically, the most obvious developments over the interval since 1984 have been the rapid succession of market crashes and scandals. These seem disproportionate in both frequency and severity to prior periods in U.S. financial history. To be sure, the market crash in 1987 now seems an isolated event that proved little (other than that the unexpected can happen). But repeated waves of scandals have followed: the 2000 dot-com crash,

¹² See generally Coffee, *supra* note 7, at 1–10.

¹³ Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, § 101, 116 Stat. 745, 750–53 (2002) (codified at 15 U.S.C. § 7211 (2006)) (creating the Public Company Accounting Oversight Board (PCAOB), a non-profit corporation whose board is accountable to the SEC for adopting and enforcing regulations of public accountants).

¹⁴ Coffee, *supra* note 7, at 265–68. New York’s Attorney General Eliot Spitzer discovered a widespread pattern under which securities analysts at investment banks were pressured or induced to inflate their recommendations and ratings for their firms’ clients. Spitzer and his staff discovered internal emails written by research analysts at Merrill Lynch that showed some analysts protesting this pressure. In April 2002, Spitzer settled with Merrill Lynch for \$100 million. Soon thereafter, the SEC, NYSE, and NASD investigated other large investment banks and found similar behavior. In April 2003, Spitzer and these agencies settled with 10 major underwriting firms for \$1.3875 billion. *Id.*; see also Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. Cin. L. Rev. 139, 161–62 (2004) (discussing Spitzer’s role in uncovering the investment banking issues and analyzing the resulting settlements).

¹⁵ For a discussion of credit rating agencies as gatekeepers and why they failed, see Coffee, *supra* note 7, at 34–35, 283–98.

the 2001–2002 accounting irregularity scandals that culminated in the bankruptcy of Enron and WorldCom, the New York Attorney General-led investigation of securities analyst conflicts of interest that resulted in a global settlement in 2003, the 2003–2004 “market timing” scandal involving mutual funds, the stock option backdating investigation that began in 2006, and lastly, and most important, the current financial crisis that first surfaced in the U.S. housing market in 2007, then spread to derivatives, and has now paralyzed most major financial institutions. All came in rapid succession, revealed pervasive misconduct by “reputational intermediaries,” and have shaken market confidence. If the rest of the world once looked to the SEC for leadership on issues of securities regulation, the SEC’s presumed leadership is very much in question today.

A related consequence of these scandals has been that a new layer of financial regulation has developed over the last decade in the United States, largely in response to SEC passivity: state regulators now have become important players in major financial scandals, often preceding the SEC in detection and enforcement. While state regulators were important prior to the enactment of the federal securities laws, they had become peripheral players by 2000.¹⁶ Their resurgence may have begun with Eliot Spitzer, but it shows no signs of ending with his political demise. Not surprisingly, the financial industry has not welcomed this new activism by state Attorneys General and would be happy to constrain or preempt them. Reorganization of financial regulation could provide politi-

¹⁶ See Howard M. Friedman, *The Impact of NSMIA on State Regulation of Broker-Dealers and Investment Advisers*, 53 *Bus. Law.* 511, 532–34, 539–45, 551–52 (1998). The National Securities Markets Improvement Act (“NSMIA”) significantly impacted the role of federal and state regulators and enforcers in dealing with securities offerings and professionals. *Id.* at 511. The NSMIA preempted many state regulations and transferred many enforcement responsibilities from the states to the federal government. In states that have not adopted regulations to mirror the NSMIA, for example, state enforcers cannot take any action to prosecute offenders. Instead, they must wait for the SEC or one of the SROs to step in. *Id.* at 522–23; see also G. Philip Rutledge, *NSMIA . . . One Year Later: The States’ Response*, 53 *Bus. Law.* 563, 570–74 (1998) (discussing NSMIA’s impact on states and how states are responding to the new shift in regulatory authority).

cal cover for legislation curbing the reach of state regulators.¹⁷ But the broader policy question first needs to be addressed: to what extent is competition among regulators desirable?

This question inevitably leads to another: what responsibility does the SEC bear for this succession of scandals and bubbles? Did the SEC and Congress move too sweepingly in dismantling investor protections? In particular, did the SEC encourage a gradual erosion in due diligence and professional standards through deregulation that gave issuers accelerated access to the capital markets and the financial industry greater latitude for self-regulation? Each episode is different, and little consensus is likely, but one common denominator may link them: the impact of rapid financial deregulation. This wave of deregulation began with the SEC's adoption of shelf registration in 1982 and continued with the passage of a series of statutes—the Private Securities Litigation Reform Act of 1995; the National Securities Markets Improvement Act of 1996; the Securities Litigation Uniform Standards Act of 1998. In the background, the gradual *de facto* repeal of the Glass-Steagall Act throughout the 1990s, culminating in the passage of the Gramm-Leach-Bliley Act of 1999 (“GLBA”), also contributed. Today, this trend toward deregulation has slowed or halted, and the Sarbanes-Oxley Act of 2002 and the Credit Rating Agency Reform Act of 2006 certainly show that, when faced with a debacle, Congress will again turn to regulatory solutions, particularly when concerned about the conduct of gatekeepers.

The suggestion that there might have been regulatory failures over this time period will produce a response from other commentators that any system that stifled the “animal spirits” of the market would have resulted in greater costs. Sharp disagreements are inevitable because attitudes toward regulation have polarized since 1984. Until the current crisis struck, critics of regulation had been arguing that the United States was losing its capital market competitiveness because it was taking a more aggressive posture towards regulation, and particularly towards enforcement, compared

¹⁷ There are hints to this effect in the U.S. Treasury Department's recent “Blueprint.” See Dep't of Treasury, *Blueprint for a Modernized Financial Regulatory Structure* 9–10, 53–58, 128–29 (2008) [hereinafter *Blueprint*].

to the other major capital markets.¹⁸ At one pole in this debate, some academics even urged that issuers should be able to choose both the corporate and securities law applicable to them, opting from an inventory that would include at least the corporate and securities laws of the major markets.¹⁹ Such choice, it was argued, would drive a process of regulatory arbitrage until, in theory, the optimal level of regulation was achieved. The current crisis is likely to mute this demand for investor choice, because in a world of collapsing and insolvent financial institutions, few favor giving them the right to choose their level of supervision. Most agree today that regulatory arbitrage inherently reduces the intensity of regulatory oversight. The first lesson of the current crisis is that externalities result when a financial institution fails; hence, issuers cannot be given unconstrained choice. In turn, a long-term precondition of international competitiveness is that a country's financial institutions be able to survive a crisis. Conversely, the current crisis also challenges those who favor stronger regulation and enforcement. After all, the current crisis began in, and largely devastated the financial landscape of, the United States, which has long had much more aggressive public and private enforcement. If higher enforcement intensity yields benefits, the United States should seemingly have been spared. That it was not suggests there are no simple answers.

Still, both those who favor and those who oppose increased financial regulation can agree on one thing: the current organization of financial regulation in the United States is inefficient or worse. Almost no one likes the status quo. A recent report of the Treasury Department, entitled "Blueprint for a Modernized Financial Regulatory Structure" (Blueprint), triggered a symptomatic reaction.²⁰ The Blueprint recommended both (1) a fundamental reorganization and consolidation of all financial regulators in the United

¹⁸ See Comm. on Capital Mkts. Regulation, *supra* note 10, at 2–6. Popularly known at the "Paulson Report," this document does conclude that the United States' more stringent regulatory policies have injured its international competitiveness. *Id.*

¹⁹ See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *Yale L.J.* 2359, 2410–17 (1998). To be sure, Professor Romano does not expressly discuss the special case of financial institutions, but her prescription of investor choice is unqualified, and choice as to disclosure rules is not fundamentally different from choice as to other regulatory regimes.

²⁰ See Blueprint, *supra* note 17, at 8–22.

States, and (2) a major shift towards a more deregulatory style that emphasizes reliance on “principles” (rather than “rules”) and self-regulation by the industry. Much like a Rorschach test, the Blueprint predictably drew diverse and vociferous responses. Few endorsed its specific recommendations; some feared that its proposed reallocation implied the demise of the SEC,²¹ but most agreed with its basic diagnosis that U.S. financial regulation had become overly fragmented. In that light, a debate over structural reform becomes unavoidable. This Article will analyze the Blueprint’s proposals, but in terms of its own very different assessment of where financial regulation has gone awry.

The consensus today is that the United States has a highly fragmented and arguably Balkanized structure of financial regulation, which approaches creating a different regulator for every class of financial institution. But what feasible alternatives exist? Part I of this Article will survey the different patterns of financial regulation that have recently emerged in the other major capital markets and also the failures that sparked these recent changes. Part II will then return to the United States and asks a simple but unavoidable question: why have there been so many recent scandals? What failures do they suggest within the U.S. regulatory system? This discussion sets the stage for an examination of the major proposals in the Treasury Department’s Blueprint. Part III will focus on the Blueprint’s proposal that U.S. financial regulation should move to a more “principles-based” system and away from its alleged current fixation on rules. Part IV similarly will examine the Blueprint’s contention that U.S. financial regulation should rely to a greater extent on self-regulation by private bodies, such as stock exchanges, which would adopt rules from broad generic principles promulgated by the securities regulator.

A common underlying theme unites the Blueprint’s separate strands: to maintain U.S. capital market competitiveness, the United States should relax its traditionally aggressive enforcement policies, either by relying more on broad principles and self-regulation by the industry, or by delegating at least some aspects of

²¹ For such a view, see Julie Satow, *Will Bernanke Doom the SEC?*, N.Y. Sun, July 11, 2008, available at <http://www.nysun.com/business/will-bernanke-doom-the-sec/81689> (reporting that some officials feared that Federal Reserve oversight of investment banks would eclipse the SEC).

oversight and enforcement to industry self-regulation. This Article rejects this argument as unpersuasive and highly ideological; indeed, it views such an attitude as a leading cause of the current crisis.

Nevertheless, this Article will conclude that the Blueprint is correct on a critical point: regulatory consolidation is necessary. Unfortunately, progress on that score may be slow. After all, it took over twenty years for Congress to dismantle the Glass-Steagall Act, even though, over much of that period, the Act's obsolescence (and eventually its irrelevance) was apparent to most. The Blueprint's call for a reallocation and consolidation of regulatory responsibilities does make sense, even if implementation of any reforms will be slow. The immediate focus should be on the SEC itself: what does it do well—and less well? Based on this evaluation, we will conclude with suggestions for a reallocation of authority between the SEC and other financial regulators that moves the “prudential” supervision of the “safety and soundness” of investment banks to banking regulators, but maintains and consolidates authority for consumer protection and oversight of business practices within the SEC.

I. REGULATORY MODERNIZATION: A BRIEF TOUR OF RECENT DEVELOPMENTS

Financial regulation in the major capital markets today follows one of three basic organizational models: the functional/institutional model, the consolidated financial services regulator model, and the “twin peaks” model.

A. The Functional/Institutional Model

The Blueprint repeatedly refers to the United States as having a “current system of functional regulation, which maintains separate regulatory agencies across segregated functional lines of financial services, such as banking, insurance, securities, and futures.”²² This is at best a partial truth. In fact, the United States falls considerably short of even a “functional” regulatory model. By design, “functional” regulation seeks to subject similar activities to regulation by

²² Blueprint, *supra* note 17, at 4, 27.

the same regulator. Its premise is that no one regulator can have, or easily develop, expertise in regulating all aspects of financial services. Thus, the securities regulator understands securities, while the insurance regulator has expertise with respect to the very different world of insurance. In the Gramm-Leach-Bliley Act of 1999 ("GLBA"), which essentially repealed the Glass-Steagall Act, Congress endorsed such a system of functional regulation.²³

Nonetheless, the reality is that the United States actually has a hybrid system of functional and institutional regulation.²⁴ The latter approach looks not to functional activity, but to institutional type. Institutional regulation is seldom the product of deliberate design, but rather of historical contingency, piecemeal reform, and gradual evolution.

To illustrate this difference between functional and institutional regulation, let us hypothesize that, under a truly functional system, the securities regulator would have jurisdiction over all sales of securities, regardless of the type of institution selling the security. Conversely, let us assume that under an institutional system, jurisdiction over sales would be allocated according to the type of institution doing the selling. Against that backdrop, what do we observe today about the allocation of jurisdiction? Revealingly, under a key compromise in GLBA, the SEC did not receive general authority to oversee or enforce the securities laws with respect to the sale of government securities by a bank.²⁵ Instead, banking regulators retained that authority. Similarly, the drafters of the GLBA carefully crafted the definitions of "broker" and "dealer" in the Securities Exchange Act of 1934 to leave significant bank securities

²³ The Conference Report to the Gramm-Leach-Bliley Act clearly states this:

Both the House and Senate bills generally adhere to the principle of functional regulation, which holds that similar activities should be regulated by the same regulator. Different regulators have expertise at supervising different activities. It is inefficient and impractical to expect a regulator to have or develop expertise in regulating all aspects of financial services.

H.R. Rep. No. 106-434, at 157 (1999) (Conf. Rep.), reprinted in 1999 U.S.C.C.A.N. 245, 252.

²⁴ For this same assessment, see Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets*, 38 *Tex. Int'l L. J.* 317, 328 (2003).

²⁵ See 15 U.S.C. § 78o-5(a)(1)(B) (2006); 15 U.S.C. § 78(c)(a)(34)(G) (2006); 15 U.S.C. § 78o-5(g)(2) (2006).

activities under the oversight of bank regulators and not the SEC.²⁶ Predictably, even in the relatively brief time since the passage of GLBA in 1999, the SEC and bank regulators have engaged in a continuing turf war over the scope of the exemptions accorded to banks from the definition of “broker” and “dealer.”²⁷

None of this should be surprising. The status quo is hard to change, and regulatory bodies do not surrender jurisdiction easily. As a result, the regulatory body historically established to regulate banks will predictably succeed in retaining much of its authority over banks, even when banks are engaged in securities activities that from a functional perspective should belong to the securities regulator.

“True” functional regulation would also assign similar activities to one regulator, rather than divide them between regulators based on only nominal differences in the description of the product or the legal status of the institution. Yet, in the case of banking regulation, three different federal regulators oversee banks: the Office of the Controller of the Currency (“OCC”) supervises national banks; the Federal Reserve Board (“FRB”) oversees state-chartered banks that are members of the Federal Reserve System and the Federal Deposit Insurance Corporation (“FDIC”) supervises state-chartered banks that are not members of the Federal Reserve System but are federally insured.²⁸ Balkanization does not stop there. The line between “banks,” with their three different regulators at the federal level, and “thrifts,” which the Office of Thrift Supervision (“OTS”) regulates, is again more formalistic than functional and reflects a political compromise more than a difference in activities.

Turning to securities regulation, one encounters an even stranger anomaly: the United States has one agency (the SEC) to regulate securities and another (the Commodities Future Trading Commission (“CFTC”)) to regulate futures. The world of deriva-

²⁶ See 15 U.S.C. § 78(c)(a)(4)–(5) (2006).

²⁷ See Kathleen Day, *Regulators Battle Over Banks: 3 Agencies Say SEC Rules Overstep Securities-Trading Law*, Wash. Post, July 3, 2001, at E3. Eventually, the SEC backed down in this particular skirmish and modified its original position. See Exchange Act Release No. 34-44570, [2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,515 (July 18, 2001).

²⁸ This is all well described in the Blueprint. See Blueprint, *supra* note 17, at 31–41.

tives is thereby divided between the two, with the SEC having jurisdiction over options, while the CFTC has jurisdiction over most other derivatives. No other nation assigns futures and securities regulation to different regulators. For a time, the SEC and CFTC both asserted jurisdiction over a third category of derivatives—swaps—but in 2000, Congress resolved this dispute by placing their regulation largely beyond the reach of both agencies. Finally, some major financial sectors (for example, insurance and hedge funds) simply have no federal regulator. By any standard, the United States thus falls well short of a true system of functional regulation, because deregulation has placed much financial activity beyond the reach of any federal regulator.

Sensibly, the Blueprint proposes to rationalize this patchwork-quilt structure of fragmented authority through the merger and consolidation of agencies. Specifically, it proposes both a merger of the SEC and CFTC and a merger of the OCC and the OTS. Alas, such mergers are rarely politically feasible, and to date, no commentator (to our knowledge) has predicted that these proposed mergers will actually occur.

Thus, although the Blueprint proposes that we move beyond functional regulation, the reality is that we have not yet approached even a system of functional regulation, since our existing financial regulatory structure is organized at least as much by institutional category as by functional activity. Disdaining a merely “functional” reorganization under which banking, insurance, and securities would each be governed by their own federal regulator, the Blueprint instead envisions a far more comprehensive consolidation of all these specialized regulators. Why? In its view, the problems with functional regulation are considerable:

A functional approach to regulation exhibits several inadequacies, the most significant being the fact that no single regulator possesses all the information and authority necessary to monitor systemic risk, or the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected.²⁹

²⁹ Blueprint, *supra* note 17, at 4.

But beyond these concerns about systemic risk, the architects of the Blueprint were motivated by a deeper anxiety: regulatory reform is necessary to maintain the capital market competitiveness of the United States.³⁰ In short, the Blueprint is designed around two objectives: (1) the need to better address systemic risk and the possibility of a cascading series of defaults, and (2) the need to enhance capital market competitiveness. As discussed later, the first concern is legitimate, but the second involves a more dubious logic.

B. The Consolidated Financial Services Regulator

A clear trend is today evident towards the unification of supervisory responsibilities for the regulation of banks, securities markets, and insurance.³¹ Beginning in Scandinavia in the late 1980s,³² this trend has recently led the United Kingdom, Japan, the Republic of Korea, Germany, and much of Eastern Europe to move to a single regulator model.³³ Although there are now a number of precedents, the U.K. experience stands out as the most influential. It was the first major international market center to move to a unified regulator model,³⁴ and the Financial Services and Markets Act, adopted in 2000, went significantly beyond earlier precedents towards a

³⁰ In particular, the Blueprint hypothesizes that the United Kingdom has enhanced its own competitiveness by regulatory reforms, adopted in 2000, that are principles-based and rely on self regulation for their implementation. *Id.* at 3.

³¹ For recent overviews, see Giorgio Di Giorgio & Carmine D. Noia, *Financial Market Regulation and Supervision: How Many Peaks for the Euro Area?*, 28 *Brook. J. Int'l L.* 463, 469–78 (2003); Eilis Ferran, *Examining the United Kingdom's Experience in Adopting the Single Financial Regulator Model*, 28 *Brook. J. Int'l L.* 257, 257–59 (2003); Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 *Brook. J. Int'l L.* 319, 319–20 (2003).

³² Scandinavian countries were the first to establish unitary financial regulators. See Di Giorgio & Noia, *supra* note 31, at 469–78. Norway established the first integrated regulatory agency in 1986, followed by Denmark in 1988, and Sweden in 1991. See Ferran, *supra* note 31, at 258.

³³ See Bryan D. Stirewalt & Gary A. Gegenheimer, *Consolidated Supervision of Banking Groups in the Former Soviet Republics: A Comparative Examination of the Emerging Trend in Emerging Markets*, 23 *Ann. Rev. Banking & Fin. L.* 533, 548–49 (2004). As discussed later, in some countries (most notably Japan), the change seems more one of form than of substance, with little in fact changing. See Markham, *supra* note 31, at 383–92, 396.

³⁴ See Ferran, *supra* note 31, at 258.

“nearly universal regulator.”³⁵ The Blueprint focuses on the United Kingdom’s experience because it believes that the United Kingdom’s adoption of a consolidated regulatory structure “enhanced the competitiveness of the U.K. economy.”³⁶

Yet it is unclear whether the United Kingdom’s recent reforms provide a legitimate prototype for the Blueprint’s proposals. Here, the Blueprint may have doctored its history. By most accounts, the United Kingdom’s adoption of a single regulator model was “driven by country-specific factors,”³⁷ including the dismal failure of a prior regulatory system that relied heavily on self-regulatory bodies but became a political liability because of its inability to cope with a succession of serious scandals. Ironically, the financial history of the United Kingdom in the 1990s parallels that of the United States over the last decade. On the banking side, the United Kingdom experienced two major banking failures—the Bank of Credit and Commerce International (“BCCI”) in 1991 and Barings in 1995. Each prompted an official inquiry that found lax supervision was at least a partial cause.³⁸

Securities regulation in the United Kingdom came under even sharper criticism during the 1990s because of a series of financial scandals that were generally attributed to an “excessively fragmented regulatory infrastructure.”³⁹ Under the then-applicable law (the Financial Services Act of 1986), most regulatory powers were delegated to the Securities and Investments Board (“SIB”), which was a private body financed through a levy on market participants. However, the SIB did not itself directly regulate. Rather, it “set the overall framework of regulation,” but delegated actual authority to second tier regulators, which consisted primarily of self-regulatory organizations (“SROs”).⁴⁰ Persistent criticism focused on the inabil-

³⁵ See Schooner & Taylor, *supra* note 24, at 329. Schooner and Taylor also observe that the precursors to the United Kingdom’s centralized regulator, which were mainly in Scandinavia, had a “predominantly prudential focus.” *Id.* at 331. That is, the unified new regulator was more a guardian of “safety and soundness” and less oriented toward consumer protection.

³⁶ Blueprint, *supra* note 17, at 3.

³⁷ Ferran, *supra* note 31, at 259.

³⁸ *Id.* at 261–62.

³⁹ *Id.* at 265.

⁴⁰ *Id.* at 266. The most important of these were the Securities and Futures Authority (“SFA”), the Investment Managers’ Regulatory Organization (“IMRO”), and the Personal Investment Authority (“PIA”).

ity or unwillingness of these SROs to protect consumers from fraud and misconduct.⁴¹ Ultimately, the then-chairman of the SIB, the most important of the SROs, acknowledged that self-regulation had failed in the United Kingdom and seemed unable to restore investor confidence.⁴² This acknowledgement set the stage for reform, and when a new Labour Government came into power at the end of the decade, one of its first major legislative acts (as it had promised in its election campaign) was to dismantle the former structure of SROs and replace it with a new and more powerful body, the Financial Services Authority (“FSA”).

Despite the Blueprint’s enthusiasm for the United Kingdom’s model, the structure that the Blueprint proposes for the United States more closely resembles the former U.K. system than the current one. Under the Blueprint’s proposals, the securities regulator would be restricted to adopting general “principles-based” policies, which would be implemented and enforced by SROs.⁴³ Ironically, the Blueprint relies on the U.K. experience to endorse essentially the model that the United Kingdom concluded had failed.

C. The “Twin Peaks” Model

As the Blueprint recognizes, not all recent reforms have followed the U.K. model of a universal regulator. Some nations—most notably Australia and the Netherlands—instead have followed a “twin peaks” model that places responsibility for the “prudential regulation of relevant financial institutions” in one agency and supervision of “business conduct and consumer protection” in another.⁴⁴ The term “twin peaks” derives from the work of Michael

⁴¹ Two scandals in particular stood out: the Robert Maxwell affair in which a prominent financier effectively embezzled the pension funds of his companies and a “pension mis-selling” controversy in which highly risky financial products were inappropriately sold to pension funds without adequate supervision or disclosure. *Id.* at 267–68.

⁴² *Id.* at 268.

⁴³ See *infra* notes 113–15 and accompanying text.

⁴⁴ Blueprint, *supra* note 17, at 3. For a recent discussion of the Australian reorganization, which began in 1996 (and thus preceded the United Kingdom), see Schooner & Taylor, *supra* note 24, at 340–41. The Australian Securities and Investments Commission (“ASIC”) is the “consumer protection” agency under this “twin peaks” approach, and the Australian Prudential Regulatory Authority (“APRA”) supervises

Taylor, a British academic and former Bank of England official. In 1995, just before regulatory reform became a hot political issue in the United Kingdom, he argued that financial regulation had two separate basic aims (or “twin peaks”): (1) “to ensure the soundness of the financial system,” and (2) “to protect consumers from unscrupulous operators.”⁴⁵ Taylor’s work was original less in its proposal to separate “prudential” regulation from “business conduct” regulation than in its insistence upon the need to consolidate “responsibility for the financial soundness of all major financial institutions [in] a single agency.”⁴⁶ Taylor apparently feared that if the Bank of England remained responsible for the prudential supervision of banks, its independence in setting interest rates may be compromised by its fear that raising interest rates would cause bank failures for which it would be blamed. In part for this reason, the eventual legislation shifted responsibility for bank supervision from the Bank of England to the FSA.

It approaches the self-evident to note that a conflict exists between the consumer protection role of a universal regulator and its role as a “prudential” regulator intent on protecting the safety and soundness of the financial institution. The goal of consumer protection is most obviously advanced through deterrence and financial sanctions, but these can deplete assets and ultimately threaten bank solvency. When only modest financial penalties are used, this conflict may sound more theoretical than real. But, as discussed later, the United States is distinctive in the severity of the penalties it imposes on financial institutions. In recent years, the SEC has imposed restitution and penalties exceeding \$3 billion annually, and private plaintiffs received a record \$17 billion in securities class

bank “safety and soundness.” Still, the “twin peaks” model was not fully accepted in Australia, as ASIC, the securities regulator, does retain supervisory jurisdiction over the “financial soundness” of investment banks. *Id.* at 341. Thus, some element of functional regulation remains.

⁴⁵ Michael Taylor, “Twin Peaks”: A Regulatory Structure for the New Century (Centre for the Study of Financial Innovation 1995). For a brief review of Taylor’s work, see Cynthia Crawford Lichtenstein, *The Fed’s New Model of Supervision for “Large Complex Banking Organizations”: Coordinated Risk-Based Supervision of Financial Multinationals for International Financial Stability*, 18 *Transnat’l Law.* 283, 295–96 (2005).

⁴⁶ Lichtenstein, *supra* note 45, at 295 (quoting Taylor, *supra* note 45, at 4) (emphasis omitted).

action settlements in 2006.⁴⁷ Over a recent ten year period, some 2,400 securities class actions were filed and resulted in settlements of over \$27 billion, with much of this cost (as in the Enron and WorldCom cases) being borne by investment banks.⁴⁸ If one agency were seeking both to protect consumers and to guard the solvency of major financial institutions, it would face a difficult balancing act to achieve deterrence without threatening bank solvency, and it would risk a skeptical public concluding that it had been “captured” by its regulated firms.

Even in jurisdictions adopting the universal regulator model, the need to strengthen enforcement contemporaneously has been part of the reform package. Although the 2000 legislation in the United Kingdom did not adopt the “twin peaks” format, it did significantly strengthen the consumer protection role of its centralized regulator. The Financial Services and Markets Act, enacted in 2000, sets out four statutory objectives, with the final objective being the “reduction of financial crime.”⁴⁹ According to Schooner and Taylor, this represented “a major extension of the FSA’s powers compared to the agencies it replaced,”⁵⁰ and it reflected a political response to the experience of weak enforcement by self-regulatory bodies, which had led to the creation of the FSA.⁵¹ With probably unintended irony, Schooner and Taylor described this new statutory objective of reducing “financial crime” as the “one aspect of U.K. regulatory reform in which its proponents seem to have drawn direct inspiration from U.S. law and practice.”⁵² Conspicuously, the Blueprint ignores that “modernizing” financial regulation in other countries has generally meant strengthening enforcement.

D. A Preliminary Evaluation

Three preliminary conclusions merit emphasis. First, whether the existing financial regulatory structure in the United States is

⁴⁷ See *infra* notes 58, 104 and accompanying text (discussing average annual SEC penalties and class action settlements).

⁴⁸ See Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 *Berkeley Bus. L.J.* 3, 3 (2007).

⁴⁹ See Financial Services and Markets Act, 2000, c. 8, § 6 (U.K.).

⁵⁰ See Schooner & Taylor, *supra* note 24, at 335.

⁵¹ *Id.* at 335–36.

⁵² *Id.* at 336.

considered “institutional” or “functional” in design, its contemporary impact seems clear: it invites regulatory arbitrage. Financial institutions position themselves to fall within the jurisdiction of the most accommodating regulator, and investment banks design new financial products so as to encounter the least regulatory oversight. Such arbitrage can be defended as desirable if one believes that regulators inherently overregulate, but not if one believes increased systemic risk is a valid concern (as the Blueprint appears to believe).

Second, the Blueprint’s history of recent regulatory reform involves an element of historical fiction. The 2000 legislation in the United Kingdom, which created the FSA as a nearly universal regulator, was not an attempt to introduce self-regulation by SROs, as the Blueprint seems to assume, but a sharp reaction by a Labour Government to the failures of self-regulation. Similarly, Japan’s slow, back-and-forth movement in the direction of a single regulator seems to have been motivated by an unending series of scandals and a desire to give its regulator at least the appearance of being less industry dominated.⁵³

Third, the debate between the “universal” regulator and the “twin peaks” alternative should not obscure the fact that, as proposed, both would be “superregulators” that would move beyond “functional” regulation on the premise that, as the lines between banks, securities dealers, and insurers blur, so regulators should similarly converge. That idea should remain at the heart of the U.S. debate, even after many of the Blueprint’s proposals are forgotten.

⁵³ Japan has a history and a regulatory culture of economic management of its financial institutions through regulatory bodies that is entirely distinct from that of Europe or the United States. Although it has recently created a Financial Services Agency, observers contend that it remains committed to its traditional system of bureaucratic regulation that supports its large banks and discourages foreign competition. See Markham, *supra* note 31, at 383–92, 396. Nonetheless, scandals have been the primary force driving institutional change there too, and Japan’s FSA was created at least in part because Japan’s Ministry of Finance (“MOF”) had become embarrassed by recurrent scandals.

II. THE U.S. CONTEXT: HAS THERE BEEN A REGULATORY FAILURE?

Whatever the trends elsewhere, a comparative survey of regulatory consolidation and reorganization cannot tell us what the United States should do. That is a prescriptive problem that simple description of changes elsewhere cannot resolve. Moreover, as just noted, the closer one looks at structural reforms in other major capital markets, the more one finds that they too were driven mainly by country-specific events (that is, scandals and politics), and not by general theory.

How then is the United States distinctive? And how should this influence the place of securities regulation within the U.S. regulatory structure? In this section, we briefly survey how the United States is different from Europe and then turn to the more controversial topic: what responsibility the SEC should bear for recent scandals and crashes. Here, we write against a backdrop where a legion of law and economics scholars have launched tirades of criticism against the Sarbanes-Oxley Act and fulminated generally about the costs of overregulation.⁵⁴ Although we do not mean to defend Sarbanes-Oxley against all criticism, we believe the current subprime mortgage meltdown and the resulting “credit crunch” reveal that there are costs to underregulation, and at present these latter costs may be greater.

A. How Is the United States Different?

Of course, this involves restating some obvious points:

1. The Higher Level of Individual Ownership

Although institutional investors may today dominate trading in the U.S. securities markets, the fact remains that most U.S. households own equity securities, and nearly three-fourths of Americans' liquid financial assets are invested in securities-related products.⁵⁵ This uniquely high level of individual ownership implies both a

⁵⁴ For the most acerbic of these attacks on Sarbanes-Oxley, see Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *Yale L.J.* 1521 (2005).

⁵⁵ For an overview, see John C. Coffee, Jr., Joel Seligman & Hillary A. Sale, *Securities Regulation: Cases and Materials* 3 (10th ed. 2007).

need for some paternalism in securities regulation and the inevitability that there will be a political demand for strong enforcement. Even the most closely comparable securities market (namely, that of the United Kingdom) is significantly different. There, securities ownership is much more concentrated in institutions, with a low and declining level of individual ownership.⁵⁶ Not surprisingly, when institutions dominate the market, there is less demand for aggressive enforcement (because today's aggrieved victim may be tomorrow's defendant). In such an environment, regulators act primarily based on consensus and discipline primarily through "regulatory frowns."

2. *The Tradition of Strong Enforcement*

Whether measured in terms of market capitalization or gross domestic product, the disparity between the levels of financial penalties imposed by the SEC versus those imposed by regulators in other major capital markets is extraordinary.⁵⁷ In recent years, the SEC has obtained penalties or financial restitution from defendants in amounts exceeding \$3 billion per year.⁵⁸ In sharp contrast, the United Kingdom's FSA imposed fines of only £5.3 million in

⁵⁶ As of October 2008, the percentage of shares held by "private investors" (that is, non-institutional shareholders) in U.K.-listed companies had fallen to 9.6% (which was consistent with the level of such ownership in the 1980s, prior to later privatization efforts by the British government). See Matthew Vincent, *Value of Private Holdings Hits Low*, *Fin. Times*, Oct. 18, 2008, at 15. At its peak, private ownership hit 20% in 1994. *Id.* During the 1990s, the level of individual ownership rose as the result of the Thatcher government's privatization of government-owned enterprises, but even this 20% level never approached the U.S. level of individual ownership, which has not fallen below 30%. See John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 *Geo. L.J.* 1727, 1768–69 (2007) (comparing U.S. and U.K. institutional ownership and revealing institutional levels of ownership in the United Kingdom in 2004 were approximately 10% higher than the United States).

⁵⁷ For detailed comparisons, see John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 *U. Pa. L. Rev.* 229, 268–74 (2007); Howell E. Jackson, *Variations in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 *Yale J. on Reg.* 253, 278–86 (2007).

⁵⁸ In 2004, 2005, and 2006, the total of SEC obtained restitution, disgorgement, and penalties was, \$3.1 billion, \$3.1 billion and \$3.275 billion, respectively. See Eric Zitzewitz, *An Eliot Effect? Prosecutorial Discretion in Mutual Fund Settlement Negotiations, 2003–07 Table 1* (Apr. 21, 2008) (unpublished manuscript, available at <http://ssrn.com/abstract=1091035>).

2007, down from £13.3 million in 2006.⁵⁹ Thus, comparing the SEC to its most closely comparable regulator, the FSA, the ratio in recoveries seems to be nearly 300 to 1 in 2007 and probably around 100 to 1 for most recent years. Moreover, the SEC is only one of several public enforcers in the United States (FINRA and the states also impose large penalties and obtain settlements). Finally, private enforcement obtains greater recoveries than public enforcement. For example, in 2006, securities class action settlements peaked at over \$17 billion. Criminal enforcement of securities fraud cases is similarly common in the United States and virtually unknown in Europe (in 2008, FSA brought the first criminal cases for insider trading in its history).

Why does the United States display greater enforcement intensity? The answer probably lies in its higher level of retail ownership (and a resulting greater political demand for enforcement). To some degree, the higher enforcement intensity in the United States may also be historically derived from a deep-seated Populist skepticism of Wall Street, which goes back at least to the late nineteenth century (and possibly earlier). Curiously, this enforcement disparity seems to be growing, even as U.S. and European corporate governance appear to be converging in other respects.

This marked variation in enforcement intensity leads to an obvious policy debate: Does the United States overenforce? Or, does the rest of the world underenforce? In this light, we think the next factor is critical.

3. Equity Compensation

During the 1990s, the United States moved almost overnight from a system in which senior managers were primarily compensated in cash to one in which they were primarily compensated in equity (through stock options).⁶⁰ This change was partly driven by

⁵⁹ See Jonathan Sibun, *Tough-Talking Regulator Hands Out Smaller Fines*, *Sunday Telegraph*, Dec. 30, 2007, at 1; *Watchdog Fines at Six-Year Low as City Keeps to Rules*, *Yorkshire Post*, Dec. 31, 2007, at 15. The average fine in 2007 was £232,000 and only one fine was over one million pounds.

⁶⁰ As of 1990, equity-based compensation for chief executive officers of large public corporations in the United States averaged approximately five percent of their total annual compensation; by 1999, this percentage had risen to an estimated sixty percent.

tax considerations and partly by institutional investor pressure (since the institutions believed that senior management was often too indifferent to their firm's stock price). Whatever the reason, the result is that corporate governance in the United States now uses a very high octane fuel to incentivize managers. As a result, there may be far greater reason for senior management in U.S. companies to inflate earnings or understate liabilities than for their counterparts in Europe to do so. This may be the common denominator that best links the stock market scandals of 2001–2002 that led to the Sarbanes-Oxley Act with the debt markets crisis of 2008. Arguably, senior executives of U.S. financial institutions opted for higher levels of leverage over the last decade, both because it enhanced profitability and because a risk-neutral stock market tolerated, and even demanded, acceptance of higher levels of risk—at least until the brink of insolvency was reached.

The ability of senior management of U.S. companies to pursue higher risk policies follows not only from the differences in compensation but also from differences in the structure of share ownership. Europe is characterized by concentrated ownership; the United States, by dispersed ownership. What Berle and Means famously described as the “separation of ownership and control” is nearly unique to the United States and the United Kingdom. In a concentrated ownership system, the controlling owners are not diversified, and they can and do monitor management, whereas in a dispersed ownership system, dispersed shareholders are both more diversified and less able to monitor or constrain management. Possibly because there are significant limitations on the ability of dispersed shareholders to monitor, greater investment in public enforcement is necessary to keep agency costs under control. Equally important, in a concentrated ownership system, controlling shareholders generally have little incentive to maximize the day-to-day stock price of their firm.⁶¹ Unlike managers in a dispersed ownership system, they cannot simply exercise stock options and dump the stock into the market, because by definition they hold large and illiquid blocks. Nor is it likely that controlling shareholders

See John C. Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, 89 *Cornell L. Rev.* 269, 275 (2004).

⁶¹See John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the USA and Europe Differ*, 21 *Oxford Rev. Econ. Pol'y* 198, 204 (2005).

plan to sell in the shortterm. Even when they do wish to sell, they will typically do so in privately negotiated control sales to an incoming controlling shareholder at a premium that is not closely related to the market price. For all these reasons, while controlling shareholders may overreach, they typically have little reason to engage in short-term market manipulation.

B. What Went Wrong?: A Very Brief Tour of the Scandals

Finger pointing and blame allocation are time-honored academic activities, which unfortunately have about the same social utility as locking the barn door after the horse has been stolen. Nonetheless, before reorganizing financial regulation from the ground up (as the Treasury's Blueprint does), it is essential to ask: What went wrong? What do these market and regulatory failures indicate about the prerequisites for effective regulation?

Where did the crisis begin? Arguably, the deeper origins of the 2008 financial meltdown may lie in deregulatory measures, taken both by Congress and the SEC, which placed some categories of derivatives and some firms beyond effective regulation.⁶² Still, most accounts of the current financial crisis start by describing the rapid inflation of a bubble in the U.S. housing market. Fair as it may be to start with the housing sector, the term "bubble" can easily become a substitute for closer analysis and may carry a misleading connotation of inevitability. In truth, bubbles fall into two basic categories: those that are demand-driven and those that are supply-driven. Most bubbles fall into the former category; that is, they are driven by the irrational exuberance of investors.⁶³ Yet, the 2008 financial market meltdown was clearly a supply-driven bubble, propelled by a sudden increase in the availability of mortgage funds to

⁶² Interestingly, this is the diagnosis that SEC Chairman Christopher Cox recently presented to the Senate Banking Committee. See *infra* notes 100, 101 and accompanying text. He stressed the failure of Congress to give the SEC jurisdiction over investment bank holding companies or over-the-counter derivatives (including credit default swaps).

⁶³ For example, the high-tech internet bubble that burst in early 2000 was a demand-driven bubble. Investors simply overestimated the value of the internet, and for a time initial public offerings of dot-com companies would trade at ridiculous and unsustainable multiples. But full disclosure was provided to investors and the SEC cannot be faulted in this bubble—unless one assigns it the very paternalistic responsibility of protecting investors from themselves.

borrowers, regardless of their creditworthiness.⁶⁴ This relaxation in lending standards did not start with mortgage originators, but was rather the product of their recognition (largely after 2000) that underwriters had become willing to buy portfolios of mortgage loans for asset-backed securitizations without seriously investigating the underlying collateral.

The evidence is clear that between 2001 and 2006, an extraordinary increase occurred in the supply of mortgage funds, with much of this increased supply being channeled into poorer communities in which previously there had been a high denial rate on mortgage loan applications.⁶⁵ With an increased supply of mortgage credit, housing prices rose rapidly, as new buyers entered the market. But at the same time, a corresponding increase in mortgage debt relative to income levels in these same communities made these loans precarious. Two University of Chicago Business School professors have found that two years after this period of increased mortgage availability began, a corresponding increase started in mortgage defaults—in exactly the same zip code areas where there had been a high previous rate of mortgage loan denials.⁶⁶ They determined that a one standard deviation in the supply of mortgages from 2001 to 2004 produced a one standard deviation increase thereafter in mortgage default rates.⁶⁷

Even more striking, however, is their finding that the rate of mortgage defaults was highest in those neighborhoods that had the highest rates of securitization.⁶⁸ Not only did securitization correlate with a higher rate of default, but that rate of default was highest when the mortgages were sold by the loan originator to financial firms unaffiliated with the loan originator.⁶⁹ Other researchers have reached a similar conclusion: conditional on being securitized, a loan portfolio that is more likely to be securitized defaults by about twenty percent more than a similar risk profile loan portfolio

⁶⁴ This is best evidenced by the work of two University of Chicago Business School professors discussed below. See Atif Mian & Amir Sufi, *The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis 2* (Dec. 12, 2008) (unpublished manuscript, available at <http://ssrn.com/abstract=1072304>).

⁶⁵ *Id.* at 11–13.

⁶⁶ *Id.* at 18–19.

⁶⁷ *Id.* at 19.

⁶⁸ *Id.* at 20–21.

⁶⁹ *Id.*

that is less likely to be securitized.⁷⁰ Why? The most plausible interpretation is that securitization adversely affects the incentives of lenders to screen their borrowers.

Such a conclusion should not surprise. It simply reflects the classic moral hazard problem that arises once loan originators do not bear the cost of default by their borrowers. Well before the financial crisis crested, the President's Working Group on Financial Markets issued a "Policy Statement on Financial Market Developments" in March 2008 that explained the crisis as the product of five "principal underlying causes of the turmoil in financial markets":

- a breakdown in underwriting standards for subprime mortgages;
- a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors, related in part to failures to provide or obtain adequate risk disclosures;
- flaws in credit rating agencies' assessment of subprime residential mortgage[s] . . . and other complex structured credit products, . . . ;
- risk management weaknesses at some large U.S. and European financial institutions; and
- regulatory policies, including capital and disclosure requirements, that failed to mitigate risk management weaknesses.⁷¹

Correct as the President's Working Group was in noting the connection between the decline of discipline in the mortgage loan origination market and a similar laxity among underwriters in the capital markets, it largely ignored the direction of the causality. In retrospect, irresponsible lending in the mortgage market appears to have been a direct response to the capital markets' increasingly in-

⁷⁰ See Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru & Vikrant Vig, *Did Securitization Lead to Lax Screening? Evidence From Subprime Loans 2-3* (Dec. 25, 2008) (unpublished manuscript, available at <http://ssrn.com/abstract=1093137>). The authors conclude that securitization did result in "lax screening."

⁷¹ The President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments 1* (Mar. 2008), available at http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf.

satisfiable demand for financial assets to securitize. If underwriters were willing to rush deeply flawed asset-backed securitizations to the market, mortgage loan originators had no rational reason to resist them.

Thus, the real mystery is not why loan originators made unsound loans, but why underwriters bought them. Anecdotal evidence suggests that due diligence efforts within the underwriting community slackened in asset-backed securitizations after 2000.⁷² Others have suggested that the SEC contributed to this decline by softening its disclosure and due diligence standards for asset-backed securitizations,⁷³ in particular by adopting in 2005 Regulation AB, which covers the issuance of asset-backed securities.⁷⁴ At this point, it becomes plausible that failures in regulatory oversight, including by the SEC, may have played a greater causal role in the debacle than has been generally emphasized (even if the SEC had no responsibility or capacity to monitor the mortgage loan origination process).

⁷² Investment banks formerly relied on “due diligence” firms that they employed to determine whether the loans within a loan portfolio were within standard parameters. These firms would investigate and inform the underwriter as to the percentage of the loans that were “exception” loans (that is, loans outside the investment bank’s normal guidelines). Subsequent to 2000, the percentage of “exception loans” in portfolios securitized by these banks often rose from the former level of 25% to as high as 80%. Also, the underwriters scaled back the intensity of the investigations that they would authorize the “due diligence” firm to conduct, reducing from 30% to as few as 5% the number of loans in a portfolio that it was to check. See Vikas Bajaj & Jenny Anderson, *Inquiry Focuses on Withholding of Data on Loans*, N.Y. Times, Jan. 12, 2008, at A1.

⁷³ See Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. Ill. L. Rev. (forthcoming 2009) (manuscript at 34–38, on file with the Virginia Law Review).

⁷⁴ See *Asset-Backed Securities*, Securities Act Release No. 33-8518, Exchange Act Release No. 34-50,905, 70 Fed. Reg. 1506 (Jan. 7, 2005) (to be codified at 17 C.F.R. pts. 210, 228, et al.). Regulation AB codified a series of “no-action” letters and established disclosures standards for all asset-backed securitizations. See *Asset-Backed Securities (Regulation AB)*, 17 C.F.R. §§ 229.1100–229.1123 (2008). Although it did not represent a sharp deregulatory break with the past, Regulation AB did reduce the due-diligence obligation of underwriters by eliminating any need to assure that assets included in a securitized pool were adequately documented. Professor Mendales has pointed out that government sponsored entities, such as Ginny Mae, had required such documentation. See Mendales, *supra* note 73, at 35–36. His point is that Regulation AB should have adopted the procedures used by housing-related GSEs, such as Ginny Mae, which mandated quality control procedures. *Id.*

Still, a diagnosis that blames the 2008 financial crisis simply on inadequate disclosure and due diligence is too simple. Deregulation enabled those investment banks that failed or merged in 2008 to significantly increase their leverage over a brief period between 2004 and 2008. Indeed, if one takes a broader “before and after” perspective, the most striking fact about the recent crisis is that the United States, as of the beginning of 2008, had five major investment banks that were not owned by a larger commercial bank: Merrill Lynch, Goldman Sachs, Morgan Stanley, Lehman Brothers and Bear Stearns. By late fall of 2008, all of these investment banks had either failed or abandoned their status as independent investment banks. Two (Bear Stearns and Merrill Lynch) had been forced at the brink of insolvency to merge with larger commercial banks in transactions orchestrated by banking regulators. One—Lehman Brothers—had filed for bankruptcy, and the two remaining investment banks—Goldman Sachs and Morgan Stanley—had converted into bank holding companies under pressure from the Federal Reserve Bank, thus moving from SEC to Federal Reserve supervision.⁷⁵ Each of these firms had survived prior recessions, market panics, and repeated turmoil and had long histories extending back as far as the pre-Civil War era. Yet, each either failed or was gravely imperiled within essentially the same six month period following the collapse of Bear Stearns in March 2008.

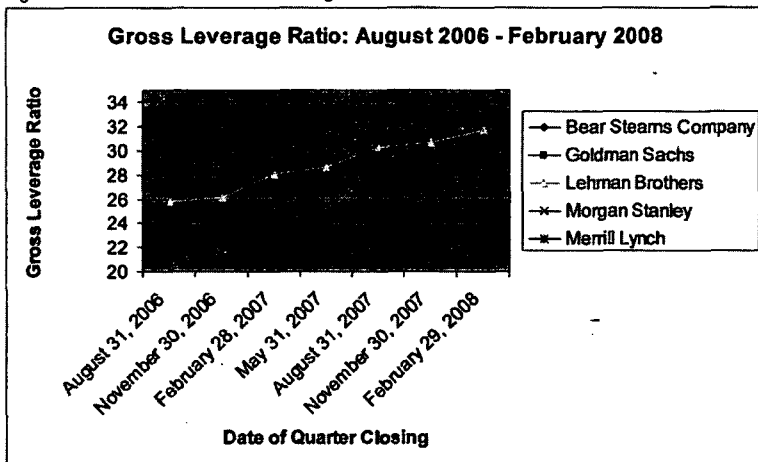
If their uniform collapse was not enough to suggest the possibility of regulatory failure, one additional fact unites them: each of these five firms voluntarily entered into the SEC’s Consolidated Supervised Entity (“CSE”) Program, which was established by the SEC in 2004 for only the largest investment banks.⁷⁶ Indeed, these five investment banks were the only investment banks permitted by the SEC to enter the CSE Program. A key attraction of the CSE Program was that it permitted its members to escape the SEC’s

⁷⁵ For a concise overview of these developments, see Jon Hilsenrath, Damian Palotta & Aaron Lucchetti, *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis*, *Wall St. J.*, Sept. 22, 2008, at A1 (reporting that Goldman Sachs and Morgan Stanley were pressured by the Federal Reserve to convert into bank holding companies).

⁷⁶ See *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities; Supervised Investment Bank Holding Companies*, Exchange Act Release No. 49,830, 69 Fed. Reg. 34,428 (June 21, 2004) (to be codified at 17 C.F.R. pts. 200, 240).

traditional net capital rule, which placed a maximum ceiling on their debt to equity ratios, and instead elect into a more relaxed “alternative net capital rule” that contained no similar limitation.⁷⁷ The result was predictable: all five of these major investment banks increased their debt-to-equity leverage ratios significantly in the period following their entry into the CSE Program, as shown by Figure 1 below:⁷⁸

Figure 1. CSE Firms- Gross Leverage Ratios



⁷⁷ The SEC’s “net capital rule,” which dates back to 1975, governs the capital adequacy and aggregate indebtedness permitted for most broker-dealers. See Net Capital Requirements for Brokers or Dealers, 17 C.F.R. § 240.15c3-1 (2008). Under subparagraph (a)(1)(i) of this rule, aggregate indebtedness is limited to fifteen times the broker-dealer’s net capital. 17 C.F.R. § 240.15c3-1(a)(1)(i) (2008). A broker-dealer may elect to be governed instead by subparagraph (a)(1)(ii) of this rule, which requires it to maintain its net capital at not less than the greater of \$250,000 or two percent of “aggregate debit items” as computed under a special formula that gives “haircuts” (that is, reduces the valuation) of illiquid securities. 17 C.F.R. § 240.15c3-1(a)(1)(ii). Both variants place fixed limits on leverage. 17 C.F.R. § 240.15c3-1(a)(1).

⁷⁸ This chart comes from Sec. & Exch. Comm’n, Office of Inspector Gen., SEC’s Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program 120 (Report No. 446-A, Sept. 25, 2008), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf> [hereinafter SEC Inspector General Report No. 446-A].

That higher leverage, coupled with a high concentration of their assets in subprime mortgages and related real estate assets, left them exposed and vulnerable when market conditions soured in 2007–2008. For example, at the time of its insolvency, Bear Stearns' gross leverage ratio had hit 33 to 1.⁷⁹

These facts may seem to corroborate a now popular hypothesis: excessive deregulation by the SEC caused the liquidity crisis that swept the global markets in 2008.⁸⁰ The problem with this simple hypothesis is that it is too simple. Deregulation may well have contributed to the 2008 financial crisis, but the SEC's adoption of the CSE Program in 2004 was not intended to be deregulatory. Rather, the program was intended to compensate for earlier deregulatory efforts by Congress that had left the SEC unable to monitor the overall financial position and risk management practices of the nation's largest investment banks. Still, even if the 2004 net capital rule changes were not intended to be deregulatory, they worked out that way in practice. The ironic bottom line is that the SEC unintentionally deregulated by introducing an alternative net capital rule that it could not effectively monitor.

The events leading up to the SEC's decision to relax its net capital rule for the largest investment banks began in 2002, when the European Union adopted its Financial Conglomerates Directive.⁸¹ The main thrust of the European Union's new directive was to require regulatory supervision at the parent company of financial conglomerates that included a regulated financial institution (e.g., a broker-dealer, bank, or insurance company). The European Union's entirely reasonable fear was that the parent company may take actions that could jeopardize the solvency of the regulated subsidiary. The European Union's directive potentially applied to

⁷⁹ See *id.* at 19.

⁸⁰ For the strongest statement of this thesis, see Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, *N.Y. Times*, Sept. 27, 2008 at A1. Nonetheless, this analysis is oversimplified. Although SEC Chairman Cox did indeed acknowledge that there were flaws in the "Consolidated Supervised Entity" Program, he did not concede that it "fueled" the collapse or that it represented deregulation. As discussed below, the SEC probably legitimately believed that it was gaining regulatory authority from the CSE Program (but it was wrong).

⁸¹ See Council Directive 2002/87/EC, 2003 O.J. (L35) 1. For an overview of this directive and its rationale, see Jorge E. Viñuales, *The International Regulation of Financial Conglomerates: A Case Study of Equivalence as an Approach to Financial Integration*, 37 *Cal. W. Int'l L.J.* 1, 2 (2006).

the major U.S. investment and commercial banks because all did substantial business in London (and elsewhere in Europe). But the European Union's directive contained an exemption for foreign financial conglomerates regulated by their home countries in a way that was deemed "equivalent" to that envisioned by the directive. For the major U.S. commercial banks (several of which operated a major broker-dealer as a subsidiary), this afforded them an easy means of avoiding group-wide supervision by regulators in Europe, because they were subject to group-level supervision by U.S. banking regulators. But U.S. investment banks had no similar escape hatch, since the SEC had no similar oversight over their parent companies. Thus, fearful of hostile regulation by some European regulators,⁸² U.S. investment banks lobbied the SEC for a system of "equivalent" regulation that would be sufficient to satisfy the terms of the directive and give them immunity from European oversight.⁸³ For the SEC, this offered a serendipitous opportunity to oversee the operations of investment bank holding companies; authority which the SEC had sought for some time. Following the repeal of the Glass-Steagall Act, the SEC had asked Congress to empower it to monitor investment bank holding companies, but it had been rebuffed. Thus, the voluntary entry of the holding companies into the Consolidated Supervised Entity program must have struck the SEC as a welcome development, and the Commission unanimously approved the program without any partisan disagreement.⁸⁴

But the CSE Program came with an added (and probably unnecessary) corollary: Firms that entered the CSE Program were permitted to adopt an alternative and more relaxed net capital rule governing their debt to net capital ratio. Under the traditional net

⁸² Different European regulators appear to have been feared by different entities. Some commercial banks saw French regulation as potentially hostile, while U.S. broker-dealers, all largely based in London, did not want their holding companies to be overseen by the United Kingdom's Financial Services Agency ("FSA").

⁸³ See Stephen Labaton, Agency's '04 Rule Let Banks Pile Up New Debt, and Risk, *N.Y. Times*, Oct. 3, 2008, at A1 (describing major investment banks as having made an "urgent plea" to the SEC in April, 2004).

⁸⁴ See *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities; Supervised Investment Bank Holding Companies*, Exchange Act Release No. 49,830, 69 Fed. Reg. 34,428 (June 21, 2004) (to be codified at 17 C.F.R. pts. 200, 240).

capital rule, a broker-dealer was subject to fixed ceilings on its permissible leverage. Specifically, it either had to (a) maintain aggregate indebtedness at a level that could not exceed fifteen times net capital,⁸⁵ or (b) maintain minimum net capital equal to not less than two percent of “aggregate debit items.”⁸⁶ For most broker-dealers, this 15 to 1 debt to net capital ratio was the operative limit within which they needed to remain by a comfortable margin.

Why did the SEC allow the major investment banks to elect into an alternative regime that placed no outer limit on leverage? Most likely, the Commission was principally motivated by the belief that it was only emulating the more modern, advanced “Basel II” standards used by the Federal Reserve Bank.⁸⁷ To be sure, the investment banks undoubtedly knew that adoption of Basel II standards would permit them to increase leverage (and they lobbied hard for such a change). From the SEC’s perspective, however, it designed the CSE Program to be broadly consistent with the Federal Reserve’s oversight of bank holding companies, and it even incorporated the same capital ratio that the Federal Reserve mandated for bank holding companies.⁸⁸ In addition, the CSE Program required

⁸⁵ See 17 C.F.R. § 240.15c3-1(a)(1) (2008).

⁸⁶ See 17 C.F.R. § 240.15c3-1(a)(1)(ii) (2008). This alternative standard is framed in terms of the greater of \$250,000 or two percent, but for any investment bank of any size, two percent will be the greater. Although this alternative standard may sound less restrictive, it was implemented by a system of “haircuts” that wrote down the value of investment assets to reflect their illiquidity.

⁸⁷ The “Basel II Accords” refers to a revised version of the international agreement that purports to specify uniform capital adequacy standards for major banks. The “Basel I Accord” was reached in 1988 by the Basel Committee on Banking Supervision of the Bank of International Settlements (which is located in Basel, Switzerland). The Basel II Accords, which were driven by the growth of trading in over-the-counter derivatives and their uncertain impact on capital adequacy, underwent sustained negotiations in the years after 2000. For a discussion of the politics surrounding this process, which did not conclude until Fall of 2005, see Stavros Gadinis, *The Politics of Competition in International Financial Regulation*, 49 *Harv. Int’l L.J.* 447 (2008). Gadinis finds that the Federal Reserve did not itself sign off on the Basel II Accords until late September 2005. *Id.* at 506 n. 192. This was well after the SEC applied these standards to participants in its Consolidated Supervised Entity Program in 2004. For a more general discussion of the Basel Committee and its non-transparent style of operation, see Anne-Marie Slaughter, *Sovereignty and Power in a Networked World Order*, 40 *Stan. J. Int’l L.* 283, 315–16 (2006).

⁸⁸ See SEC Inspector General Report No. 446-A, *supra* note 78, at 10–11. Under these standards, a “well-capitalized” bank was expected to maintain a ten percent capital ratio. *Id.* Nonetheless, others have argued that Basel II “was not designed to be used by investment banks” and that the SEC “ought to have been much more care-

its participants to maintain “tentative net capital” of at least \$1 billion and to notify the Commission if tentative net capital fell below \$5 billion.⁸⁹ The difference may seem modest; the SEC may have been overreached, but it was not “captured.” Still, this difference goes to the agency’s integrity.

So what went wrong? The SEC’s Inspector General examined the failure of Bear Stearns and the SEC’s responsibility therefor, and reported that Bear Stearns had remained in compliance with the CSE Program’s rules at all relevant times.⁹⁰ Thus, if Bear Stearns had not cheated, this implied (as the Inspector General found) that the CSE Program, itself, had failed. That conclusion seems fair enough, but it leads to a larger question: Why did the CSE program fail?

Here, three distinct hypotheses, all of which are complementary and could each be correct to a degree, stand out. First, the Basel II Accords might have been deeply flawed, both because they relied heavily on the banks’ own models of risk and on the risk ratings assigned to banks by highly conflicted credit rating agencies.⁹¹ Second, even if the Basel II Accords were adequate for commercial banks, they were ill-suited for investment banks, whose smaller capital base, lesser access to the Federal Reserve window, and more volatile earnings may have necessitated higher capital ratios in their case.⁹² Third, even if the Basel II Accords generated a rele-

ful in moving banks on to the new rules.” See Mewling and Puking: How Damaged is the Basel 2 Accord?, *Economist*, Oct. 25, 2008, at 89.

⁸⁹ SEC Inspector General Report No. 446-A, *supra* note 78, at 11.

⁹⁰ *Id.* at 10.

⁹¹ This critique has been most fully advanced by Daniel Tarullo, whom President Obama has recently nominated to join the Board of Governors of the Federal Reserve System. See Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* 152–59 (2008). Professor Tarullo argues that the new risk-adjusted criteria adopted by Basel II largely allowed the major banks to specify their own risk models and thereby reduce their capital ratios. Also, Basel II motivated them to move transactions off their balance sheets. In short, he argues that Basel II led to laxer bank supervision generally. *Id.* at 160–66.

⁹² See Mewling and Puking, *supra* note 88, at 89. Ironically, the Federal Reserve hesitated and did not formally accept Basel II until September 30, 2005, nearly a year after its endorsement by the SEC. See Gadinis, *supra* note 87, at 506 n. 192. See also Rebecca Christie, *Rules on Bank Capital Draw Fire: FDIC Move May Delay Final Accord Covering World Financial System*, *Wall St. J.*, Dec. 8, 2003, at B8. This suggests that the SEC moved faster and further towards deregulation and the use of pri-

vant and sensible model for the regulation of capital adequacy at investment banks, the SEC may have been simply incapable of measuring the banks' compliance with such standards.

Although recent commentary suggests that the Basel II Accords relied excessively on self-regulation by allowing banks to use their own risk models to determine capital adequacy, the SEC's implementation of its CSE program was a case apart, since the SEC moved faster and farther towards self-regulation than did the Federal Reserve.⁹³ In particular, the SEC proved incapable of close monitoring of capital adequacy. All financial institutions know that increasing leverage is the simplest way to raise profits (at least in good times), and hence they have strong incentives to design their risk models so as to enable them to increase their level of leverage.⁹⁴ Critics have also suggested that banks of all varieties evaded Basel II's norms by moving financial transactions off their balance sheets. Although attempts to game the regulatory system characterized commercial banks as well, they did not become fully subject to Basel II until a later point. In contrast, the SEC alone raced to adopt Basel II. Yet, the unique fact about the SEC's performance (according to both the SEC Inspector General's report and the public testimony of SEC Chairman Cox) was the inability of its staff to monitor the investment banks participating in the CSE program or to demand specific actions by them. Basel II's approach to the regulation of capital adequacy at financial institutions contemplated close monitoring and supervision. Thus, the Federal Reserve assigns members of its staff to maintain an office within a regulated bank holding company in order to provide constant oversight. In the case of the SEC, however, a team of only three SEC staffers were assigned to each CSE firm,⁹⁵ and a total of

vate models for risk regulation than did the Federal Reserve, possibly with the result that financial disaster first struck at the investment banks.

⁹³The SEC adopted its CSE program in 2004. See *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities; Supervised Investment Bank Holding Companies*, Exchange Act Release No. 49,830, 69 Fed. Reg. 34,428 (June 21, 2004) (to be codified at 17 C.F.R. pts. 200, 240). The Federal Reserve only agreed in principle to Basel II in late 2005. See Gadinis, *supra* note 87, at 506 n.192.

⁹⁴Citibank, for example, "actually boasted after the release of the Basel II formula in 2004 that it could reduce its minimum capital by about 15 percent." Robert Kuttner, *A Fine Mess*, *Am. Prospect*, Dec. 2008, at 37, 39.

⁹⁵SEC Inspector General Report No. 446-A, *supra* note 78, at 2.

only thirteen individuals comprised the SEC's Office of Prudential Supervision and Risk Analysis that oversaw and conducted this monitoring effort.⁹⁶ From the start, it was a mismatch: three SEC staffers to oversee an investment bank the size of Merrill Lynch, which could easily afford to hire scores of highly quantitative economists and financial analysts, implied that the SEC was simply outgunned.⁹⁷

This mismatch was compounded by the inherently individualized criteria upon which Basel II relies. Instead of applying a uniform standard (such as a specific debt to equity ratio) to all financial institutions, Basel II contemplated that each regulated financial institution would develop a computer model that would generate risk estimates for the specific assets held by that institution and that these estimates would determine the level of capital necessary to protect that institution from insolvency. Thus, using the Basel II methodology, the investment bank generates a mathematical model that crunches historical data to evaluate how risky its portfolio assets were and how much capital it needed to maintain to protect them. Necessarily, each model was ad hoc, fitted to that specific financial institution. But no team of three SEC staffers was in a position to contest these individualized models or the historical data used by them. Thus, the impact of the Basel II methodology was to shift the balance of power in favor of the management of the investment bank and to diminish the negotiating position of the SEC's staff. Even if Basel II's criteria were not inherently flawed, at the least they generated a very sophisticated tool that was beyond the capacity of the SEC's largely legal staff to administer effectively.

The SEC's Inspector General's Report bears out this critique by describing a variety of instances surrounding the collapse of Bear Stearns in which the SEC's staff did not respond to red flags that the Inspector General, exercising twenty-twenty hindsight, considered obvious. The Report finds that, although the SEC's staff were aware that Bear Stearns had a heavy and increasing concentration

⁹⁶ Id. Similarly, the Office of CSE Inspectors had only seven staff. Id.

⁹⁷ Moreover, the process effectively ceased to function well before the 2008 crisis hit. After SEC Chairman Cox reorganized the CSE review process in the Spring of 2007, the staff did not thereafter complete "a single inspection." See Labaton, *supra* note 83, at A23.

in mortgage securities, they “did not make any efforts to limit Bear Stearns’ mortgage securities concentration.”⁹⁸ In its recommendations, the Report proposed both that the staff become “more skeptical of CSE firms’ risk models” and that they “develop additional stress scenarios that have not already been contemplated as part of the prudential regulation process.”⁹⁹

The Inspector General’s proposed reform, however, may expect more of the SEC’s staff than they can realistically deliver. Under the CSE program, the SEC’s staff had no power other than to threaten ouster from the program. Unlike a prophylactic rule (such as the SEC’s traditional net capital rule that placed a uniform ceiling on leverage for all broker-dealers), the identification of “additional stress scenarios” by the SEC’s staff would not necessarily lead to specific actions by the CSE firms; rather, such attempts at persuasion are more likely to produce only an extended dialogue, with the SEC’s staff being confronted with counter-models and interpretations by the financial institution’s managers. Ouster, if at all, would occur much later, perhaps even too late.

Our sense that the SEC cannot negotiate successfully for voluntary compliance in an area where the investment banks have strong economic interests to increase their leverage is confirmed by a similar assessment from the person with perhaps the most recent experience in this area. In his September, 2008 testimony before a Senate committee, SEC Chairman Christopher Cox emphasized the infeasibility of voluntary compliance, expressing his frustration with attempts to negotiate issues such as leverage and risk management practices with the CSE firms. In a remarkable statement for a long-time proponent of deregulation, he testified: “[B]eyond highlighting the inadequacy of the . . . CSE program capital and liquidity requirements, the last six months—during which the SEC and the Federal Reserve have worked collaboratively with each of the CSE firms . . .—*have made abundantly clear that voluntary regulation doesn’t work.*”¹⁰⁰ His point was that the SEC had no in-

⁹⁸ SEC Inspector General Report No. 446-A, *supra* note 78, at ix.

⁹⁹ *Id.* at xi.

¹⁰⁰ See Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs, 110th Cong. 4 (2008) [hereinafter Turmoil in U.S. Credit Markets] (testimony of Christopher Cox, Chairman,

herent authority to order a CSE firm to reduce its debt to equity ratio or to keep it in the CSE Program.¹⁰¹ If it objected, a potentially endless regulatory negotiation might only begin, and the CSE firm could at least threaten to leave the program. Armed only with the sanction of ouster from the CSE program, the SEC's staff were handcuffed and did little to resist rapid increases in leverage at all the CSE participants.

Ultimately, even if one absolves the SEC of "selling out" to the industry in adopting the CSE Program in 2004, it is still clear at a minimum that the SEC lacked both the power and the expertise to restrict leverage by the major investment banks, at least once the regulatory process entitled each bank to generate its own risk model. Motivated by stock market pressure and the incentives of a short-term oriented executive compensation system, senior management at these institutions effectively converted the process into self-regulation.

One last factor also drove the rush to increased leverage: competitive pressure. The major investment banks were in active competition to obtain inventory from the major loan originators, and this gave the loan originators leverage. Needing an assured source of supply, some investment banks (most notably Lehman and Merrill, Lynch) invested heavily in acquiring loan originators and related real estate companies, thus in effect vertically integrating.¹⁰²

Sec. & Exch. Comm'n), available at http://banking.senate.gov/public_files/COXTestimony92308.pdf (emphasis added). Chairman Cox has repeated this theme in a subsequent Op-Ed column in the Washington Post, in which he argued that "[r]eform legislation should steer clear of voluntary regulation and grant explicit authority where it is needed." See Christopher Cox, Op-Ed., *Reinventing a Markets Watchdog*, Wash. Post, Nov. 4, 2008, at A17.

¹⁰¹ Chairman Cox added in the next sentence of his Senate testimony: "There is simply no provision in the law that authorizes the CSE Program, or requires investment bank holding companies to compute capital measures or to maintain liquidity on a consolidated basis, or to submit to SEC requirements regarding leverage." *Turmoil in U.S. Credit Markets*, supra note 100, at 6. This is true, but if a CSE firm left the CSE Program, it would presumably become subject to European regulation (from which it was exempt only because the CSE participants were subject to U.S. financial supervision at the parent company level). See supra notes 81-84 and accompanying text. Thus, the system was not entirely voluntary and the SEC might have used the threat to expel a non-compliant CSE firm.

¹⁰² See Gretchen Morgenson, *How the Thundering Herd Faltered and Fell: Merrill Lynch Couldn't Escape the Housing Crash*, N.Y. Times, Nov. 9, 2008, at B1 (analyzing Merrill Lynch's failure and emphasizing its acquisitions of loan originators); Terry

In so doing, they assumed even greater risk by increasing their concentration in real estate and thus their undiversified exposure to a downturn in that market. This need to stay at least even with one's competitors best explains the now famous line uttered by Charles Prince, the then-CEO of Citigroup in July, 2007, just as the debt market was beginning to collapse. Asked by the *Financial Times* if he saw a liquidity crisis looming, he answered:

When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.¹⁰³

In short, competition among the major investment banks can periodically produce a mad momentum that sometimes leads to a lemmings-like race over the cliff. This in essence happened in the period just prior to the 2000 dot-com bubble, again during the accounting scandals of 2001–2002, and most recently during the subprime mortgage debacle. Once the market becomes hot, the threat of civil liability—either to the SEC or to private plaintiffs in securities class actions—seems to constrain this momentum only weakly. Rationalizations for staying in the race are always available: “real estate prices never fall,” “the credit rating agencies gave this deal a ‘Triple A’ rating,” etc. Explosive growth and a decline in professional standards often go hand in hand. Here, after 2000, due diligence standards appear to have been relaxed, even as the threat of civil liability in private securities litigation was growing.¹⁰⁴

This erosion in professional standards occurred not coincidentally just as asset-backed securitizations were becoming the princi-

Pristin, Risky Real Estate Deals Helped Doom Lehman, N.Y. Times, Sept. 17, 2008, at C6 (discussing Lehman's expensive, multi-billion dollar acquisition of Archstone-Smith).

¹⁰³ See Michiyo Nakamoto & David Wighton, Bullish Citigroup Is ‘Still Dancing’ to the Beat of the Buy-Out Boom, FT.com, July 10, 2007, http://www.ft.com/cms/s/0/5cefc794-2e7d-11dc-821c-0000779fd2ac.html?nclick_check=1.

¹⁰⁴ From 1996 to 1999, the settlements in securities class actions totaled only \$1.7 billion; thereafter, aggregate settlements rose exponentially, hitting a peak of \$17.1 billion in 2006 alone. See Laura E. Simmons & Ellen M. Ryan, Securities Class Action Settlements: 2006 Review and Analysis 1 (Cornerstone Research 2006), available at http://securities.cornerstone.com/pdfs/settlements_2006.pdf. This decline of due diligence practices as liability correspondingly increased seems paradoxical, but may suggest that at least private civil liability does not effectively deter issuers or underwriters.

pal underwriting activity of most major investment banks. In 2002, a critical milestone was reached: in that year the amount of debt securities issued in asset-backed securitizations equaled (and then exceeded in subsequent years) the amount of debt securities issued by public corporations.¹⁰⁵ Debt securitizations were not only the leading business of Wall Street, since a global market of debt purchasers was ready to rely on investment grade ratings from the major credit rating agencies, but they were also particularly important for the independent investment banks in the CSE Program. Although all underwriters anticipated high rates of return from securitizations, the independent underwriters had gradually been squeezed out of their traditional line of business—underwriting corporate securities—in the wake of the step-by-step repeal of the Glass-Steagall Act. Beginning well before the formal repeal of that Act in 1999, the major commercial banks had been permitted to underwrite corporate debt securities and had increasingly exploited their larger scale and synergistic ability to offer both bank loans and underwriting services to gain an increasing share of this underwriting market. Especially for the smaller investment banks (for example, Bear Stearns and Lehman), the future lay in new lines of business, where, as nimble and adaptive competitors, they could steal a march on the larger and slower commercial banks. To a degree, both did, and Merrill eagerly sought to follow in their wake.¹⁰⁶ To stake out a dominant position, the CEOs of these firms adopted a “damn-the-torpedoes-full-speed-ahead” approach that led them to make extremely risky acquisitions. Their common goal was to assure themselves a continuing source of supply of subprime mortgages to securitize, in part because they feared that commercial banks could fence them out by acquiring regional banks. In pursuit

¹⁰⁵ For a chart showing the growth of asset-backed securities in relation to conventional corporate debt issuances over recent years, see Coffee, Seligman & Sale, *supra* note 55, at 10.

¹⁰⁶ For a detailed description of Merrill Lynch’s late entry into the asset-backed securitization field and its sometimes frenzied attempt to catch up with Lehman by acquiring originators of mortgage loans, see Morgenson, *supra* note 102, at B1. Merrill eventually acquired an inventory of \$71 billion in risky mortgages, in part through acquisitions of loan originators. By mid-2008, an initial writedown of \$7.9 billion forced the resignation of its CEO. As discussed in this *New York Times* article, loan originators dealing with Merrill believed it did not accurately understand the risks of their field. *Id.* For Lehman’s similar approach to acquisitions of loan originators, see *supra* note 102 and accompanying text.

of this goal, both Merrill Lynch and Lehman made risky acquisitions, in effect vertically integrating into the mortgage loan origination field. These decisions, plus their willingness to acquire mortgage portfolios well in advance of the expected securitization transaction, left them undiversified and exposed to large write-downs when the real estate market soured.

So where does this brief history leave us? Our contention is not that excessive leverage and inadequate risk management policies were the sole causes of the 2008 financial crisis. Much blame can also be fairly assigned to other culpable parties, including the credit rating agencies, mortgage originators, and Congress for deregulating over-the-counter derivatives in 2000.¹⁰⁷ Nor were the investment banks alone in pursuing high leverage and de-emphasizing risk management practices. The private equity firms and some hedge funds also experienced a similar bubble and may yet in some cases face insolvency.¹⁰⁸ But the unique fact about financial institutions in general, and investment banks in particular, is their fragility. They finance their business using short-term capital to hold long-term illiquid assets. This mismatch particularly exposes investment banks to liquidity crises, and, as a crisis mounts, their counter-parties back away and refuse to trade with them. This has happened before cyclically, well within the memory of the chief executives run-

¹⁰⁷ The Commodity Futures Modernization Act of 2000 (“CFMA”) largely withdrew swaps and other over-the-counter derivatives from the regulatory jurisdiction of both the SEC and the CFTC (although both retained anti-fraud jurisdiction). See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763. For an overview, see Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 *Ann. Rev. Banking & Fin. L.* 375, 389–95 (2005). The SEC’s authority to adopt anti-fraud rules relating to over-the-counter derivatives is set forth in Section 10(b) of the Securities Exchange Act of 1934. See 15 U.S.C. § 78j(b) (2006). Because such transactions are effected on a bilateral basis, with little resulting transparency, however, the SEC has had little success to date in combating insider trading or manipulation in this area.

¹⁰⁸ See Andrew Ross Sorkin & Michael J. de la Merced, *Debt Linked to Huge Buyouts Is Tightening the Economic Vise*, *N.Y. Times*, Nov. 3, 2008, at A1 (discussing problems with recent buyouts by private equity firms); see also Peter Lattman, Craig Karmin & Pui-Wing Tam, *Private Equity Draws the Cold Shoulder—Endowments, Pension Funds Rebuff Calls to Make Investments as Some Aim to Offload Stakes*, *Wall St. J.*, Nov. 4, 2008, at C1.

ning these institutions.¹⁰⁹ Then as now, the SEC was not effective in dealing with this problem.

Others have suggested that SEC deregulation also resulted in inadequate disclosure and insufficient due diligence.¹¹⁰ Here, we are less certain whether abbreviated disclosure played a significant causal role, but relaxed due diligence was symptomatic of this era. Even if we give the SEC the benefit of the doubt on this score, the conclusion still seems inescapable that the SEC was an ineffective monitor of leverage and risk management policies at financial institutions under its jurisdiction, from at least the time of the Drexel Burnham bankruptcy in 1990 through the current crisis. Equally important, a major reason for its failure, as SEC Chairman Cox has proclaimed,¹¹¹ was the SEC's need to rely on "voluntary" cooperation and engage in extended negotiations with the investment banks over an issue that was central to these banks' profitability. This is hardly an endorsement for the Blueprint's call for greater self-regulation.

Perhaps this may seem to be an academic criticism because the CSE Program is today moribund, and the remaining investment banks have reconstituted themselves as bank holding companies. But, for the future, the critical issue is what agency or agencies should supervise hedge funds, insurance companies, and other financial institutions that are "too big to fail." Inherently, this in-

¹⁰⁹ In 1990, Drexel Burnham Lambert Group, Inc., the parent company in a financial conglomerate that included a large broker-dealer subsidiary, encountered a financial crisis and became unable to roll over its commercial paper, and its counter-parties similarly declined to trade with it. Its bankruptcy (and that of its broker dealer subsidiary) led Congress to enact the Market Reform Act of 1990 to add Section 17(b) to the Securities and Exchange Act of 1934. For a review of this last major broker-dealer insolvency before the current crisis, see Sec. & Exch. Comm'n, Office of Inspector Gen., SEC's Oversight of Bear Stearns and Related Entities: Broker-Dealer Risk Assessment Program 1 (Report No. 446-B, Sept. 25, 2008), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-b.pdf>. The foregoing SEC Inspector General's Report found the Commission to have poorly implemented the Broker-Dealer Risk Assessment Program that had been established pursuant to § 17(h) in response to the Drexel bankruptcy. *Id.* at v.

¹¹⁰ For this view, see Richard Mendales, *supra* note 73, at 34–38. Professor Mendales argues convincingly that (1) the focus of disclosure should be on the quality of the collateral in the securitized pool, not on the historical returns on mortgages, and (2) underwriters should be required to perform sufficient due diligence to document all the loans in the pool. Regulation AB did neither.

¹¹¹ See *supra* notes 100–101 and accompanying text.

volves two issues: (1) Who can best monitor the safety and soundness of these institutions: the SEC, the Federal Reserve or some new entity, and (2) what role can safely be given to industry self-regulation? Against this backdrop, we turn next to the Treasury's proposals.

III. CAN PRINCIPLES REPLACE RULES?

Recent discussions about reforming the SEC, including the Blueprint, have been laced with earnest invocations of the superiority of "principles" as a basis for any regulatory reform and a corresponding denigration of "rules-based" regulation.¹¹² Like others, the Blueprint stresses that a quick change to a principles-oriented system is vital to maintaining global competitiveness.¹¹³ The financial industry generally agrees.¹¹⁴ Accordingly, this section reviews the literature on the principles versus rules debate. Not surprisingly, we conclude, first, that our current system maintains a subtler balance between the two than has generally been recognized and, second, that without rules, enforcement, and any sense of parity therein, this system would decline in ways that business would actually find unpalatable.

The standard analysis—both legal and economic—has long recognized that a principles-based system of regulation is broader and more fluid than its rules-based counterpart. Where a rule deline-

¹¹² See, e.g., Jeremy Grant, *US Firms Lobby for Regulation by Principles*, *Fin. Times*, Sept. 17, 2007, at 22 (reporting the praising of the proposed switch to a principles-based regulatory regime because it would improve both regulation enforcement and U.S. capital market competitiveness in the world); Adam Shell, *Paulson Criticizes Regulation*, *USA Today*, Nov. 21, 2006, at 4B (quoting Paulson as saying that we must "rise above a rules-based mind-set . . . and adopt a more principles-based approach").

¹¹³ See, e.g., Jenny Anderson, *On Paper, Wall Street Gets Its Way*, *N.Y. Times*, Apr. 1, 2008, at C1; Grant, *supra* note 112, at 22; Shell, *supra* note 112, at 4B (stating that Paulson's speech was spurred on by industry complaints about rules that dampen competitiveness). But see Doidge, Karolyi & Stulz, *supra* note 10, at 4-5 (arguing that it is "simply wrong" to interpret the growth of market share in London as "evidence of a decline in the attractiveness of U.S. exchanges").

¹¹⁴ See Anderson, *supra* note 113, at C1 (quoting Lehman Brothers CLO saying that he thought that the proposal for a principles-based system would be "a major step forward"); Grant, *supra* note 112, at 22 (noting that Jamie Dimon, chief executive at JP Morgan Chase, and Dick Kovacevich, chairman of Wells Fargo, spearheaded an effort to lobby Washington to change the regulatory structure from a rules-based system to a principles-based system because it would "improve the competitiveness of capital markets").

ates, *ex ante*, allowed conduct, a principle provides a more general description of acceptable conduct.¹¹⁵ The regulator charged with enforcing the principle decides, *ex post*, whether particular conduct is acceptable and whether the conduct in question violates the principle.¹¹⁶

This balance between the *ex ante* decision under a rules-based regime and the *ex post* decision under a principles-based system is best illustrated by using the example of alternative ways to regulate speed limits.¹¹⁷ A speed limit crafted as a rule may prohibit driving above seventy miles an hour. Anyone who does so breaks the rule. That is as simple as it can get, and the regulator, or fact-finder, need only find that the speed exceeded the limit and apply the penalty.

In contrast, a speed limit crafted as a principle may simply prohibit driving at an excessive speed. This is even simpler to draft, but harder to apply. Now, the fact-finder must examine the relevant circumstances, which could include many factors from weather to age, driving experience, and type of vehicle, in order to determine what speeds are excessive. Different conditions could yield different results. In addition, the fact-finder would have to determine the actual speed and then apply the condition-based principle to that speed. Over time, one suspects that prosecutors, fearing reversal, may enforce the principles-based prohibition only in more egregious cases. Empirical observers may report that prosecutions occurred only when some other factor (suspected drunk driving, extreme high speed, or reckless driving behavior) was observed.

¹¹⁵ See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *Duke L.J.* 557, 559–60 (1992); see also Henry M. Hart, Jr. & Albert M. Sacks, *The Legal Process: Basic Problems in the Making and Application of Law* 155–58 (1958); Frederick Schauer, *Playing by the Rules: A Philosophical Examination of Rule-Based Decision-Making in Law and in Life* 12–15 (1991); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 *Harv. L. Rev.* 1685 (1976); Pierre Schlag, *Rules and Standards*, 33 *U.C.L.A. L. Rev.* 379 (1985).

¹¹⁶ Kaplow, *supra* note 115, at 560.

¹¹⁷ Almost all commentators seem to have used this example. See, e.g., Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 *Am. Bus. L.J.* 1, 6 (2008); Kaplow, *supra* note 115, at 560; Frederick Schauer, *The Tyranny of Choice and the Rulification of Standards*, 14 *J. Contemp. Legal Issues* 803, 803–04 (2005).

Clearly, the above described speed-limit rule is easier and less costly to enforce than its principle counterpart. Because a rule is easy to apply, it is often said to promote values like precision and certainty, equality and uniformity, and predictability and transparency.¹¹⁸ Transparency and certainty are maximized because the rule's application leads to specific and known consequences.¹¹⁹ These factors, in turn, affect the way in which regulators decide whether to enforce certain laws and how often.¹²⁰ Clear and easy rules prompt easy, lower cost enforcement.¹²¹

Still, these advantages are tempered by countervailing disadvantages. A rule, because it is certain, does not allow for flexibility or substantive equality.¹²² It can be over- or under-inclusive, and can encourage behavior that is socially irresponsible up to the line it draws.¹²³ In addition, when times change, rules may need to change, but that process may be slow and costly, requiring in the case of administrative regulations, promulgation, debate, and revision.¹²⁴

In contrast, the speeding principle allows for flexibility.¹²⁵ Here, if the fact-finder determines the weather and lighting were sufficient to allow a speed of 70 miles per hour, then 70 it is. In alternative conditions, the allowed limit may be 50. Drivers face uncertainty,

¹¹⁸ See, e.g., Kennedy, *supra* note 115, at 1688 (noting that rules promote “restraint of official arbitrariness and certainty”); see also Schlag, *supra* note 115, at 384 (describing the argument that the “sharp line” drawn by rules promotes certainty and understandability).

¹¹⁹ See, e.g., Kaplow, *supra* note 115, at 563 (“Because learning about a rule is cheaper, individuals may spend less in learning about the law, and may be better guided by a rule since the law’s content can be more readily ascertained.”).

¹²⁰ See, e.g., *id.* (arguing that rules are cheaper to enforce because the majority of costs are borne during promulgation, whereas principles require additional costs for each instance of enforcement).

¹²¹ See, e.g., *id.* at 573 (arguing that rules become cheaper than standards as the frequency of enforcement increases).

¹²² See, e.g., Schlag, *supra* note 115, at 384–85 (describing how the “sharp line” drawn by rules may mete out seemingly disproportionate punishment).

¹²³ See Kennedy, *supra* note 115, at 1695 (noting that with rules, “sometimes perfectly innocent behavior will be punished, and that sometimes plainly guilty behavior will escape sanction”); see also Kaplow, *supra* note 115, at 591 (noting that rules may prohibit socially acceptable behavior while failing to prohibit undesirable behavior).

¹²⁴ See, e.g., Kaplow, *supra* note 115, at 562 (noting that “[r]ules are more costly to promulgate than standards because rules involve advance determinations of the law’s content”).

¹²⁵ See, e.g., *id.* at 560 (describing how “[a] standard may entail leaving both specification of what conduct is permissible and factual issues for the adjudicator”).

but gain the ability to adapt their behavior to changes in weather, car design, or circumstances. Further, a principle need not be redefined when circumstances change, because the principle incorporates adaptive flexibility up front.

To be sure, flexibility has its downsides. Neither those trying to abide by the law nor those doing the enforcing are certain what “it” is.¹²⁶ Both have to assess and interpret the principle.¹²⁷ The regulator then has to attempt to enforce its interpretation of the uncertain principle. Those with ample resources have greater incentive to contest the principle’s application to them. The result can be variation, more opportunities for manipulation and risky behavior, as well as increased enforcement costs as regulators struggle to define the inappropriate behavior and then enforce that standard on those who will argue the conduct was not within the intended definition.¹²⁸ As the simple speeding example makes clear, this debate has multiple dimensions. Neither side wins—absolutely. The right choice of a rules-based or principles-based system depends on the circumstances. To the extent that a principles-based standard is more costly for the regulator to enforce and to the extent that the regulator is resource constrained, a principles-based system may result in less enforcement, lower penalties, and a larger de facto zone of regulatory immunity for those subject to it.

Although the debate about rules-based and principles-based standards often occurs as if the two never overlap, in reality they usually coexist.¹²⁹ Indeed, the use of the term “based,” as in “principles-based” or “rules-based,” is illuminating. Most systems are really combinations of the two, with the major difference being the

¹²⁶ See, e.g., Schlag, *supra* note 115, at 385 (describing how the uncertainty surrounding standards may create “confusion about what is or is not permissible”).

¹²⁷ See, e.g., *id.* at 387 (describing how standards require evaluative judgments by subordinates which “increase the likelihood of erroneous determinations”).

¹²⁸ See, e.g., Kaplow, *supra* note 115, at 562–63 (noting that “standards are more costly for .. enforcement authorities to apply because they require later determinations of the law’s content”); Schlag, *supra* note 115, at 385 (describing the argument that with unclear standards, “decision makers in borderline cases are likely to reach erratic results”).

¹²⁹ See, e.g., Kaplow, *supra* note 115, at 561 (noting that “legal commands mix [rules and standards] in varying degrees”); Kennedy, *supra* note 115, at 1688 (describing rules and standards as “distinct but overlapping”).

location of the system's center of gravity in one or the other system.¹³⁰

The U.S. securities regime has obvious examples of both. Consider the types of financial disclosures required by Regulation S-K. This telephone book-length regulation controls the disclosures that companies must make when seeking to offer securities to the public and when crafting the required annual reports. Regulation S-K operates by delineating required disclosures. Many of its provisions also contain specific materiality thresholds, or rules.¹³¹ But the certainty thereby afforded is undercut by, for example, Rule 12b-20 under the Securities Exchange Act, which obligates an issuer to disclose “[i]n addition to the information expressly required to be included in a statement or report, . . . such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.”¹³² Thus, the SEC's disclosure instructions backstop a series of rules with a general principle. Not surprisingly, the SEC likes to wear both a belt and suspenders.

Now consider Item 404 of Regulation S-K.¹³³ It requires disclosure of transactions exceeding \$120,000 between the issuer and directors, officers, and 5% stockholders (as well as the family members of those groups).¹³⁴ It also requires disclosure of related entities in which these groups have an interest greater than 10%, at least when 10% is the materiality threshold for this provision.¹³⁵ Here, then, is an example of a precise disclosure rule. It is just one

¹³⁰ See, e.g., Lawrence A. Cunningham, A Prescription to Retire the Rhetoric of “Principles-Based Systems” in Corporate Law, Securities Regulation, and Accounting, 60 Vand. L. Rev. 1411, 1413 (2007).

¹³¹ See 17 C.F.R. § 229.402 (2008) (defining the materiality threshold of compensation information by enumerating a list of material elements of the compensation); 17 C.F.R. § 229.601 (2008) (defining the materiality threshold of contracts that must be filed and disclosed with the registration statement to the SEC); 17 C.F.R. § 229.903 (2008) (defining, by an enumerated list, specific activities or events that constitute a “material risk” and should be reported in a disclosure statement to investors).

¹³² 17 C.F.R. § 240.12b-20 (2008).

¹³³ 17 C.F.R. § 229.404 (2008).

¹³⁴ See *id.*

¹³⁵ See *id.*

of many contained in the Regulation S-K, which is one of the most lengthy Regulations the SEC has promulgated.¹³⁶

A requirement like that contained in Item 404 is clear. Because it is clear, violations are more straightforward. Either a company discloses all of the required transactions or it does not. Straightforward violations are easier to prove. If the violation is easy to spot and prove, enforcing the regulation is also easy.¹³⁷ Herein lies the rub. Industry may well want a principles-based system because it is more difficult to enforce, and will, therefore, result in fewer enforcement actions.¹³⁸ Rest assured, however, that more is involved in the debate.

The next issue is that of safe harbors.¹³⁹ Contrast Item 404—a quintessential example of a rules-based system—with the way that industry has pressed for a safe harbor on the definition of materiality. Material misstatements or omissions can, of course, result in liability.¹⁴⁰ The definition of the term “material” thus determines when liability arises. According to the Supreme Court, the key question in this definition is whether a reasonable investor would care. Not all information is equal. Information is material, however, if there is a “substantial likelihood that [a] disclosure . . . would [be] viewed by [a] reasonable investor as having significantly altered the ‘total mix’ of information made available.”¹⁴¹ This judicial definition is a principle. In order to determine whether a misstatement is material, you have to determine who the “reasonable” investor is, what information that investor would find

¹³⁶ See John C. Coffee, Jr., Joel Seligman & Hillary A. Sale, *Federal Securities Laws: Selected Statutes, Rules and Forms* 242–377 (2008).

¹³⁷ See Cunningham, *supra* note 130, at 1424.

¹³⁸ See Anderson, *supra* note 113, at C1 (quoting former SEC commissioner Harvey J. Goldschmid as opining that some principles-based “advocates want broad principles that will not be enforced”).

¹³⁹ Safe harbors, or delineated protections, exist throughout the securities laws and regulations. See, e.g., 15 U.S.C. § 78u-5 (providing safe harbor protection for forward-looking statements accompanied by meaningful cautionary language); Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2008) (defining when certain purchases or sales of securities by an insider are exempt from insider trading liability).

¹⁴⁰ See, e.g., 17 C.F.R. § 240.10b5-1 (creating liability for purchasing or selling securities based upon “material nonpublic information”); *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 445 (1976) (court states that liability may be conditioned upon material omissions of facts that a reasonable investor would have found important in deciding whether to invest).

¹⁴¹ *TSC Indus., Inc.*, 426 U.S. at 449.

significant, and what information appropriately constitutes the “total mix.” The result is uncertainty about the principle’s reach.

Ironically, despite the vehement calls by industry for a shift to a principles-based securities regime, it has long and inconsistently fought the use of a principle for defining materiality, demanding instead a more specific “rule.”¹⁴² The arguments it deploys focus on certainty and consistency.¹⁴³ The business community wants a sharp-edged safe harbor so that it can make disclosure decisions free of liability concerns.¹⁴⁴ In short, the argument for a rules-based approach to materiality is that industry needs to know for certain whether and when to disclose. The SEC¹⁴⁵ and the courts¹⁴⁶ have expressed a preference for a materiality principle, long declining to provide any bright-line rule and arguing that to do so would likely encourage risky behavior, right up to any threshold drawn.¹⁴⁷

If Item 404 provides the classic illustration of a rule, then Rule 10b-5 provides an equally useful archetypal example of a principles-based regulation.¹⁴⁸ Rule 10b-5 supplies the jurisdictional basis for most securities litigation and the vast majority of the damages imposed on corporate issuers.¹⁴⁹ For liability to attach under Rule

¹⁴² See, e.g., *Basic, Inc. v. Levinson*, 485 U.S. 224, 236 (1988) (rejecting industry’s argument for a bright-line “agreement-in-principle” test to determine materiality).

¹⁴³ See, e.g., Brief for Petitioners at 24, *Basic*, 485 U.S. 224 (No. 86-279), 1987 WL 881061 (quoting *Flamm v. Eberstadt*, 814 F.2d 1169, 1177 (7th Cir. 1987) (arguing that a rule would have “the benefits of certainty”).

¹⁴⁴ See, e.g., *Basic*, 485 U.S. at 236 (noting that support for a bright-line rule “seems to be directed solely at the comfort of corporate managers”).

¹⁴⁵ SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (1999) (rejecting the use of a numerical threshold to determine materiality).

¹⁴⁶ See, e.g., *Basic*, 485 U.S. at 236 & n.14 (acknowledging the benefits of bright-line rules but dismissing the notion as “unrealistic”); see also *In re Columbia Sec. Litig.*, 747 F. Supp. 237, 243 (S.D.N.Y. 1990) (noting that the Supreme Court has endorsed a fact-specific test for materiality despite some advantages of a bright-line rule).

¹⁴⁷ See, e.g., *Basic* 485 U.S. at 236 (“A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress’ policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.”).

¹⁴⁸ 17 C.F.R. § 240.10b-5 (2008).

¹⁴⁹ *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 773 (2008) (referring to 10b-5 claim as “prominent feature of federal securities regulation”); *Coffee*, supra note 57, at 267 (arguing that actual financial sanctions imposed by private enforcement exceed those of public enforcement); see, e.g., A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss*

10b-5, there must be a material misstatement or omission, made with scienter, on which a person relies in purchasing or selling securities, and that causes the person damages.¹⁵⁰ Scienter is the element receiving the greatest judicial attention. Case law interpreting it abounds. The issue is what level of state of mind speakers must have before they can be held responsible for an alleged material misstatement or omission.¹⁵¹

Here again, industry has regularly called for reform and pushed for changes to increase certainty and predictability. In 1995, Congress responded with the Private Securities Litigation Reform Act,¹⁵² which, among other changes, provided for heightened pleading of scienter-based claims.¹⁵³ The reforms were designed to placate industry.¹⁵⁴ The legislation resulted in significant increases in the dismissal of claims at the pleading stage as well as a continuing battle over how to define scienter.¹⁵⁵ After over a decade of litigation under the 1995 statute, the Supreme Court finally jumped into the fray, again in response to complaints about uncertainty.¹⁵⁶ In 2007, the Court issued its *Tellabs* opinion that industry praised¹⁵⁷ and touted as clarifying the standard, or making it more rule-like.¹⁵⁸

Under the Private Securities Litigation Reform Act, 2 J. Empirical Legal Stud. 125, 129–30 (2005).

¹⁵⁰ See, e.g., *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976).

¹⁵¹ See Pritchard & Sale, *supra* note 149, at 129–30.

¹⁵² Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

¹⁵³ § 101, 109 Stat. at 737–49.

¹⁵⁴ See, e.g., Pritchard & Sale, *supra* note 149, at 126–27; Hillary A. Sale, Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA's Internal-Information Standard on '33 and '34 Act Claims, 76 Wash. U. L.Q. 537, 552–61 (discussing and citing legislative history and calls for reform).

¹⁵⁵ See Pritchard & Sale, *supra* note 149, at 129–31; see also *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2504–05 (2007).

¹⁵⁶ See, e.g., Petition for a Writ of Certiorari at 3, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499 (2007) (No. 06-484), 2006 WL 2849388 (arguing that the Supreme Court should resolve the “split of authority” regarding the “strong inference” standard).

¹⁵⁷ See, e.g., Stephen Labaton, *Investors' Suits Face Higher Bar, Justices Decide*, N.Y. Times, June 21, 2007, at A1 (noting industry praise for the Supreme Court's heightened standard in *Tellabs*).

¹⁵⁸ See, e.g., Press Release, Sec. Indus. & Fin. Mkts. Ass'n, *Tellabs Case: Supreme Court Hands Industry 2nd Major Victory in 2 Weeks* (June 21, 2007), available at <http://www.sifma.org/news/46739784.shtml> (arguing that the ruling “lends certainty and uniformity” to the standard).

But this praise may have been premature—the decision’s actual impact is less clear. Early opinions have produced results that likely have surprised industry. For example, on remand, the Seventh Circuit held in the *Tellabs* case that the complaint survived the new-improved, more rule-like standard.¹⁵⁹ As a result, the case has now survived the motion to dismiss.¹⁶⁰ Other cases have reached a similar result.¹⁶¹ A possible message of these decisions may well be that, under pressure, principles mutate into rules. That is, decisionmakers try and reduce the uncertainty surrounding a principle, and, as they do so, it becomes easier to enforce—like the speed limit of seventy miles per hour.¹⁶²

What do we learn from these examples? First, it is obvious that straightforward rules tend to be easier to interpret and enforce. In part, the ease of enforcement of rules may well account for the industry’s preference for a principles-based system.¹⁶³ Second, we learn that industry does not truly want a principles-based system without substantial qualifications and exemptions. Indeed, in some cases, industry has pushed for standards to migrate to the rule-end of the spectrum.¹⁶⁴ Thus, presumably, any quick shift to a principles-based system would be accompanied by demands for bright-line rules in areas where litigation and enforcement tend to occur, like materiality or 10b-5 fraud claims. Third, then, it appears that industry’s real interest is in a hybrid system. Yet, as we have just seen, the U.S. disclosure regime is just that, a combination of rules and principles. It is not alone. Most other systems, regardless of how they are touted, are also hybrids.¹⁶⁵

All this suggests that movement in either direction along the rules/principles continuum is unlikely to provide any quick or easy fix to the U.S. securities regime. Scrapping the entire system in fa-

¹⁵⁹ *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702, 712 (7th Cir. 2008).

¹⁶⁰ *Id.*

¹⁶¹ *Mississippi Pub. Employees’ Ret. Sys. v. Boston Scientific Corp.*, 523 F.3d 75, 78–79 (1st Cir. 2008) (reversing district court dismissal and finding scienter adequately pleaded under *Tellabs*).

¹⁶² See Schauer, *supra* note 117, at 809–11 (arguing that decision-makers push standards into rule-like form).

¹⁶³ See Anderson, *supra* note 113, at C1.

¹⁶⁴ On the migration of standards to rules from the perspective of decision-makers, see Schauer, *supra* note 117, at 809–11.

¹⁶⁵ See Ford, *supra* note 117, at 51.

vor of a new-and-improved principles system would create uncertainty, not only because it was principles-based, but also because it would be new. Indeed, a new system may well create at least a short-term litigation boon as lawyers attempted to “prosecute” cases under the revised principles-based system.

Here, under the system of contingent fee motivated entrepreneurial litigation that the United States has long and uniquely accepted, private attorneys can and do obtain very large settlements in the course of enforcing the securities laws and regulations.¹⁶⁶ Industry presumably does not want an increase in such actions or settlements, particularly when accompanied by a concomitant increase in uncertainty about new principles. Thus, any discussions about reforms to the U.S. system must include consideration of the environment in which securities disclosure takes place and in which it is enforced. Our system emphasizes *ex post* adjudication of fraud issues, chiefly through private securities litigation based on Rule 10b-5 and a few other implied private causes of action.¹⁶⁷ Although there have been many proposals for reform and virtually everyone supports some reform in principle,¹⁶⁸ no specific proposal has yet achieved broad support.

Our concern is that any significant movement towards a truly principles-based regulatory model will aggravate existing problems with private litigation. Unless greater attention is given to the impact of these proposals on civil litigation, the “solution” may well be worse than the “problem.” Here, the Blueprint falls short. Although it states various broad themes, it neither addresses seriously the problems of consumer protection, nor explains how the principles-based regime would provide industry the protections it seeks. Good reform requires precisely that sort of attention, with a

¹⁶⁶ See Simmons & Ryan, *supra* note 104, at 1.

¹⁶⁷ Historically, the implied private cause of action arose under Rule 14a-9, which addresses fraud in proxy statements. See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (noting that private securities litigation is a “necessary supplement to Commission action”).

¹⁶⁸ See, e.g., Letter from Donald C. Langevoort, Professor of Law, Georgetown University Law Center, to Christopher Cox, Chairman, Securities and Exchange Commission, and Attached Questions and Issues for Discussion (Aug. 2, 2007) (on file with the Virginia Law Review) [hereinafter Letter from Donald C. Langevoort] (signed on behalf of James D. Cox, Jill Fisch, Michael A. Perino, Adam C. Pritchard & Hillary A. Sale) (noting diversity of signors and urging Commission to address concerns about investor protection, competitiveness, and litigation system).

clearer focus on the U.S. public and private enforcement environments, the role of class actions, and the high level of retail ownership in the United States.¹⁶⁹

If one recognizes that the goal of consumer protection must be balanced against the goal of reducing abusive litigation,¹⁷⁰ that balancing quickly becomes exceedingly complex. Precisely for this reason, the tradeoffs in any reforms should be explicit. One such tradeoff may be to determine whether industry would prefer to refashion the ex ante, rules-based disclosure requirements into a more principles-based system, with the ex post litigation enforcement provisions remaining in place. Although that might mean that consumers would receive less specific information about a particular company upfront, consumers would still have an ex post principles-based enforcement remedy. Conceivably, we could trim the Regulation S-K rules and refashion many of them as principles, enforceable through a general anti-fraud prohibition that relied on a broad “principles-based” definition of materiality. Industry would gain a principles-based disclosure system, subject to ex post litigation and enforcement. We doubt, however, that such a system would quickly gain a consensus of support.

Suffice it to say that these types of tradeoffs may explain why there are cyclical debates about massive systemic reform, but only infrequent changes of any consequence.¹⁷¹ As history reveals, politics intervene.¹⁷² The result is fewer changes than debates.

¹⁶⁹ See *id.* at 2.

¹⁷⁰ In fairness, the Blueprint does concede this. See Blueprint, *supra* note 17, at 21 (“The United States has the strongest and most liquid capital markets in the world. This strength is due in no small part to the U.S. financial services industry regulatory structure, which promotes consumer protection and market stability.”); see also Letter from Donald C. Langevoort, *supra* note 168, at 1–2.

¹⁷¹ See, e.g., John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 *Bus. Law.* 447, 447 (1995); see also Blueprint, *supra* note 17, at 197–206 (documenting Executive Branch studies of markets and reform proposals over the years).

¹⁷² Historians have made the unsurprising point that revisions of securities laws have come in waves, which, over the last 300 years, have generally followed market crashes. See Stuart Banner, *What Causes New Securities Regulation?: 300 Years of Evidence*, 75 *Wash. U. L.Q.* 849, 850 (1997). Absent a market crash and its destabilizing impact on politics, powerful interest groups, such as the securities industry, can usually overcome or stall efforts by disorganized investors to adopt “reform” legislation.

IV. THE ROLE OF SELF-REGULATION

U.S. securities regulation is generally thought to promote a liquid and efficient capital market.¹⁷³ Part of the legitimacy of securities regulation comes from its enforcement system. Though many have debated whether U.S. enforcement, and in particular private securities litigation, is excessive, all that can clearly be shown is that enforcement is better funded and more rigorous in the United States than elsewhere, not that it is excessive.¹⁷⁴ Indeed, as Part II of this Article makes clear, the United States has recently weathered a series of corporate frauds that suggest that corporate decision-makers have not been deterred, let alone overdeterred. Any arguments for reform, then, should fully address these issues. The Blueprint does not.

Despite the range of industry and gatekeeping failures documented in Part II of this Article, the Blueprint offers three proposals tied to regulation and enforcement, which, to varying degrees, seek to allow industry to self-regulate and seemingly will decrease enforcement. First, as discussed in Part III, the Blueprint urges a regulatory system based on core principles, but, as just argued, a principles-based system will likely decrease enforcement. Second, the Blueprint urges preemption of state securities enforcement. State securities regulators, however, have been important fraud detectors and arbitrators, who have, at times created competition pressuring the SEC to take action.¹⁷⁵ Third, the Blueprint asserts that the “ideal” regime would be one in which the federal govern-

¹⁷³ See Henry M. Paulson, Sec’y, Dep’t of Treasury, Remarks on the Competitiveness of U.S. Capital Markets Economic Club of New York (Nov. 20, 2006), available at <http://www.ustreas.gov/press/releases/hp174.htm> (stating that the U.S. capital markets are the “deepest, most efficient, and most transparent in the world” and that the regulatory structure is “second to none”); Roberta Romano, *The Genius of American Corporate Law* 136–37 (1993) (comparing the U.S. capital markets with those of other countries and showing how much more liquid the U.S. capital markets are); Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 Va. L. Rev. 1509, 1518–19 (1997) (stating that, as compared with other countries, the U.S. capital markets are fairly liquid and trading is cheap).

¹⁷⁴ See, e.g., Pritchard & Sale, *supra* note 149, at 126 (noting “dearth” of empirical work on securities litigation reform); see also Coffee, *supra* note 57, at 258–63 (showing greater enforcement “output” in United States versus other major market centers); Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. Cal. L. Rev. 1239, 1297 (2007) (comparing foreign enforcement regimes).

¹⁷⁵ Blueprint, *supra* note 17, at 179–80.

ment's role in fraud enforcement would diminish dramatically and the self-regulatory organizations, themselves public companies, would become the enforcers and consumer protectors.¹⁷⁶

To examine these proposals, it is important to focus more concretely on what exactly would be delegated and to whom. Under the Blueprint, the disclosure system currently in place would continue to be managed by a federal body, the Corporate Finance Regulator.¹⁷⁷ Thus, on some level, the consumer protection afforded by the disclosure side of the system would remain in place.

Still, our mandatory disclosure system has long co-existed with a strong anti-fraud rule. Disclosures must not be misleading, either affirmatively or by half-truth or omission.¹⁷⁸ Most recognize that fraud in the marketplace has significant costs.¹⁷⁹ Policing the market for fraud is important to promote consumer protection, liquidity, and efficiency. In essence, the securities statutes aimed at punishing fraud allow for "public confidence" in the market.¹⁸⁰ Shareholders and other market monitors can make accurate investment decisions only if disclosures are sufficiently fulsome and truthful.¹⁸¹ Fraud, of course, interferes with such assessments and, thereby, decreases the accountability of managers.¹⁸² In addition, over time, as markets become unreliable, shareholders will decline to invest or will demand a higher premium because of the market's tolerance

¹⁷⁶ *Id.* at 178–79.

¹⁷⁷ *Id.* at 21.

¹⁷⁸ See, e.g., Donald C. Langevoort, *Half-Truths: Protecting Mistaken Inferences by Investors and Others*, 52 *Stan. L. Rev.* 87, 117 (1999) (explaining that both courts and SEC regulators require people to "volunteer any . . . information necessary to make [their statements] not misleading" to avoid liability in fraud-on-the-market cases).

¹⁷⁹ These costs have been thoroughly explored elsewhere and here are discussed only briefly. See, e.g., A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 *Va. L. Rev.* 925 (1999).

¹⁸⁰ See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005).

¹⁸¹ See Pritchard, *supra* note 179, at 937–45 (noting that the wrong projects can also be funded); see also Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 *Mich. L. Rev.* 2498, 2544 (1997). Thus, both investors and companies are making inefficient decisions. See Pritchard, *supra* note 179, at 938–39. But see Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 *Va. L. Rev.* 623, 633–34 (1992) (remarking that inefficient decision-making by investors in secondary markets probably does not impose "much of an allocative loss on society").

¹⁸² See James D. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 *Geo. Wash. L. Rev.* 745, 747 (1984).

of fraud. Then, liquidity decreases¹⁸³ and the cost of capital increases.¹⁸⁴ Of course, excessive deterrence may also reduce market efficiency by leading corporate managers to be overly cautious in their forward-looking statements or even to understate income.

Thus, from either perspective, fraud must be punished, but neither too much nor too little, because serious errors are possible in both directions. When courts or the SEC approach this issue of damage assessment, they usually analyze the topic from one of two alternative perspectives: compensation or deterrence.¹⁸⁵ In reality, compensation is only minimally achieved in today's enforcement and litigation world, and arguably properly so.¹⁸⁶ Deterrence is also an elusive target, but it can be imposed in two forms: through actual payment of civil damages and other enforcement penalties or through litigation and its associated costs. The Blueprint sidesteps the issue of private litigation, stating only that "[i]mplied private rights of action" are "for the courts to determine."¹⁸⁷ Further, al-

¹⁸³ See Nicholas L. Georgakopoulos, *Frauds, Markets, and Fraud-on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud*, 49 U. Miami L. Rev. 671, 707 (1995); Jonathan R. Macey & David D. Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. Ill. L. Rev. 315, 326 (1985).

¹⁸⁴ See Coffee, *supra* note 57, at 300–11 (discussing evidence on the relationship between enforcement and the cost of capital).

¹⁸⁵ See *Dura Pharm.*, 544 U.S. at 345 (noting that deterring fraud is the key objective of securities laws).

¹⁸⁶ See Stephanie Planchich, Svetlana Starykh & Brian Saxton, NERA (National Economic Research Associates) Economic Consulting, 2008 Mid-Year Update, 2008 Trends: Subprime and Auction-Rate Cases Continue to Drive Filings, and Large Settlements Keep Averages High (July 2008) at 20, available at http://www.nera.com/image/BRO_Recent_Trends_8.5x11_0808.pdf (revealing that securities class action settlements average between 2.2% and 3.2% of investors' total market losses); see also John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 Colum. L. Rev. 1534, 1547–56 (2006) (arguing that a class action system can be justified only in terms of deterrence); Donald C. Langevoort, *Capping Damages for Open-Market Securities Fraud*, 38 Ariz. L. Rev. 639, 646–51 (1996) (arguing that compensation is not a necessary part of the securities package); Pritchard, *supra* note 179, at 946–47 ("Deterrence, not compensation, is the answer to the problems of loss of liquidity, reduced managerial accountability, and distorted capital allocation.").

¹⁸⁷ Blueprint, *supra* note 17, at 118. Interestingly, at several other points the Blueprint states that implied rights of action should be harmonized across securities. See, e.g., *id.* at 116–18. At least with respect to the implied right of action for 10b-5 Claims, the Supreme Court has spoken. See *Stoneridge Inv. Partners, LLC v. Scientific-*

though much recent academic commentary has stressed the likely superiority of public enforcement over private enforcement,¹⁸⁸ the Blueprint takes precisely the opposite approach, attacking first state, and then federal, enforcement and proposing to minimize both through delegation to the SROs.

The Blueprint's assault on state enforcement is straightforward: it should be preempted.¹⁸⁹ This suggestion is not new.¹⁹⁰ Industry has repeatedly urged preemption of state securities law and enforcement.¹⁹¹ In fact, in 1996, NSMIA did preempt much of the states' securities regulatory apparatus for securities traded in national markets, but it left state anti-fraud enforcement largely intact.¹⁹²

In contrast, the Blueprint focuses not on state regulation in the sense of rule-making and oversight, but on state enforcement of anti-fraud rules. Increasingly, state Attorneys General have played an aggressive role in prosecuting securities fraud and have pushed the SEC to be more vigorous in its own enforcement efforts.¹⁹³ The Blueprint's proposal, however, would preclude the New York Attorney General's office from playing the central role that it recently has. In support of such preemption, the Blueprint notes that

Atlanta, Inc., 128 S. Ct. 761, 773 (2008) (stating that with the PSLRA, Congress "ratified the implied right of action" and "accepted [the] private cause of action").

¹⁸⁸ See, e.g., Howell E. Jackson & Mark J. Roe, Public and Private Enforcement of Securities Laws: Resource-Based Evidence 33, (Harvard Pub. Law Working Paper No. 08-28), available at <http://ssrn.com/abstract=1000086> (concluding that public enforcement is at least as effective, if not more effective, as private enforcement in obtaining favorable financial market outcomes).

¹⁸⁹ Blueprint, *supra* note 17, at 20.

¹⁹⁰ See, e.g., Kathleen Day, Brokerage Settlement Leaves Much Unresolved: SEC Acknowledges Need for New, Specific Rules, Wash. Post, Apr. 30, 2003, at E1 (describing Wall Street's push "to make it clear that federal securities laws preempt state laws").

¹⁹¹ See, e.g., Vincent Di Lorenzo, Federalism, Consumer Protection and Regulatory Preemption: A Case for Heightened Judicial Review, 10 U. Pa. J. Bus. & Emp. L. 273, 275-80 (2008) (describing industry criticism of and efforts to preempt state regulatory enforcement).

¹⁹² Blueprint, *supra* note 17, at 172-73. Section 18(c)(1) of the Securities Act of 1933 does, however, preserve the authority of the states "to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions." See 15 U.S.C. § 77(r)(c)(1) (2006). Thus, in 1996 in enacting NSMIA, Congress did endorse a continued anti-fraud role for state attorneys general.

¹⁹³ Coffee, Seligman & Sale, *supra* note 55, at 1277-78 (discussing role of Eliot Spitzer in Enron investigations and prosecutions).

the “current multi-agency business conduct oversight structure creates uneven enforcement, potential enforcement gaps, disputes over jurisdiction, and regulatory inconsistency.”¹⁹⁴ All that may be to some degree true, but such “multi-agency oversight” also produces competition, which in turn leads to more aggressive enforcement and fills gaps. Recent experience suggests that this is a form of regulatory competition that actually appears to have worked. If one believes securities fraud tends to be under-enforced, competition between regulatory agencies is desirable in that it creates a failsafe check and balance against the prospect of regulatory capture. Even if one believes the reverse, automatic preemption does not logically follow.

Part II has already noted that then Attorney General Elliot Spitzer was ahead of the SEC in the investigation of securities analyst conflicts and “market timing” in mutual funds. The same can be said for the Enron investigation, where Spitzer used New York’s unusually flexible securities law to investigate the role of the investment banks in the Enron fraud.¹⁹⁵ By all accounts, he was once again “out in front of” the SEC and his investigations created pressure on the SEC to enter the battle and insist on a settlement with the banks.¹⁹⁶ Indeed, at the time of Spitzer’s investigation, it was unclear whether the SEC intended to pursue the banks at all, let alone aggressively.¹⁹⁷

The phenomenon of the New York Attorney General stealing a march on the SEC is not limited to the brief reign of Eliot Spitzer. More recently, his successor, Andrew Cuomo, has been the most aggressive enforcer in the auction rate securities cases, negotiating settlements with the major investment banks totaling well over \$50 billion.¹⁹⁸ Earlier, Attorney General Cuomo reached the first set-

¹⁹⁴ Blueprint, *supra* note 17, at 172.

¹⁹⁵ Coffee, Seligman & Sale, *supra* note 55, at 1277.

¹⁹⁶ See, e.g., Sale, *supra* note 14, at 161–63.

¹⁹⁷ See, e.g., Stephen Labaton with Patrick McGeehan, S.E.C. Queries Large Brokers On Research, N.Y. Times, May 1, 2002, at C1 (quoting Spitzer’s doubts about the SEC’s intentions of conducting an investigation); see also Stephen Labaton, S.E.C. Chief Vows to Act on Mutual Funds, N.Y. Times, Nov. 8, 2003, at C1 (detailing criticism of the SEC for its failure to investigate fraud allegations as quickly as state regulators).

¹⁹⁸ Andrew Ross Sorkin, Cuomo Seeks Settlements with 3 More Banks, N.Y. Times DealBook, Aug. 11, 2008, <http://dealbook.blogs.nytimes.com/2008/08/11/cuomo-targets-3-more-banks-in-auction-rate-inquiry/?scp=1&sq=cuomo%20banks&st=cse>

tlements with the credit rating agencies.¹⁹⁹ Other Attorneys General have also played a significant role, along with the SEC, in resolving similar cases.²⁰⁰

Not only have the State Attorneys General frequently been first, they have often been tougher. A recent study by Eric Zitzewitz of the restitution involved in mutual fund cases is particularly revealing.²⁰¹ It compares restitution in cases involving both the New York Attorney General's office and the SEC, with those involving the SEC alone.²⁰² The study concluded that the cases with both "prosecutors" yielded considerably higher restitution ratios.²⁰³ The study controlled for a variety of factors to reach the conclusion that the higher restitution in the cases with the New York Attorney General appear to be attributable to its relative aggressiveness.²⁰⁴ Further, the study concludes that the "aggressiveness explanation" is consistent with the career concerns of the regulator as well as with regulatory capture theories.²⁰⁵

Under the system proposed by the Blueprint, the most that a State Attorney General could do, if so inclined, would be to "suggest" an investigation, or at least raise the question of one, with the

(describing various settlements with Citigroup, UBS, Morgan Stanley, and Bank of America where the banks have either made or agreed to make settlements totaling \$47.5 billion).

¹⁹⁹ See Jenny Anderson & Vikas Bajaj, *Rating Firms Seem Near Legal Deal On Reforms*, N.Y. Times, June 4, 2008, at C1 (listing various changes that Cuomo was negotiating with the credit rating agencies in order to improve the transparency of the ratings process); Reuters, *Rating Agencies Reach Settlement Over Fees*, N.Y. Times, June 6, 2008, http://www.nytimes.com/2008/06/06/business/06cuomo.html?_r=1&scp=1&sq=Rating%20Agencies%20Reach%20Settlement%20Over%20Fees&st=cse (discussing the deal that was reached with the credit rating agencies and the reforms that the agencies have agreed to implement).

²⁰⁰ See, e.g., Jennifer Bayot, *Franklin Places Three on Leave for Fund Trading*, N.Y. Times, Dec. 23, 2003, at C12 (detailing the investigative roles of state regulators in Massachusetts and California).

²⁰¹ Zitzewitz, *supra* note 58.

²⁰² *Id.* at 4 (noting that settlements not involving the New York Attorney General's office had the lowest restitution ratios among those in sample).

²⁰³ *Id.* (settlements involving New York had ratios of .78, while those with the SEC alone, had ratios of .07).

²⁰⁴ *Id.* at 4-5.

²⁰⁵ *Id.* at 30-31.

various federal regulators and self-regulatory bodies. From there, the state could proceed only with their approval.²⁰⁶

The Blueprint also neglects to address the incentives of state regulators to pursue such violations. The Zitzewitz study, however, makes clear that accounting for those incentives is important.²⁰⁷ Career concerns and the favorable publicity that accompanies such investigations appear to motivate (at least in part) the decision to pursue them.²⁰⁸ Despite this fact, the Blueprint proposes that state regulators be urged instead only to investigate and bring questions to the attention of the federal regulators. Then, state regulators should be content with walking away when they are preempted from carrying out the investigation. Yet, as the Enron and market timing cases make clear, the state regulators have been important gap-fillers in the existing system, with the subsequent regulatory competition benefiting both investors and the market.

These benefits do not mean that regulatory competition between state and federal enforcers never produces problems or inconsistencies. But when it does, the more politically accountable approach would be to force the SEC to take public action to preempt the state regulator. This approach both has political costs for the SEC (as it should) and adds transparency to the process. To assume that the SEC would always resist state enforcement by desiring its preemption is an extraordinarily arbitrary presumption. Thus, we suggest an alternative mechanism for resolving actual conflicts between state and federal enforcers in the concluding section of this Article.

²⁰⁶ Blueprint, *supra* note 17, at 180 (“For example, given the experience of state officials with state-chartered financial institutions or other locally based knowledge of business conduct issues (e.g., complaints regarding certain business practices in local areas), state officials could bring these issues to CBRA’s attention. Based upon that local information, state officials could be given the authority to proceed with full investigations and enforcement actions if approved by CBRA. An alternative to this grant of authority to state officials should be for CBRA (or the appropriate SRO) to use such information to further investigate compliance issues and take enforcement actions as necessary. In both cases, the goal should be to build off the local knowledge of state officials and to provide an appropriate role for states in business conduct oversight.”).

²⁰⁷ Zitzewitz, *supra* note 58, at 4–5 (noting that when New York gets involved in prosecuting a case, the restitution-to-harm ratio increases significantly and implies that New York pursues such prosecution more aggressively).

²⁰⁸ *Id.* at 30–31.

Next, let us consider the distinct proposal of the Blueprint that most of the SEC's power be delegated to the SROs. Despite an extraordinary recent outpouring of criticism over the failure of the gatekeepers,²⁰⁹ the Blueprint never even addresses this topic or the alleged enforcement capacity of the SROs. Nor does it address the SRO failures that led the United Kingdom to replace self-regulation with the FSA.²¹⁰ Instead, in support for the proposal to shift responsibility to the SROs, the Treasury Report offers the following bland paragraph:

A number of models could be considered to implement CBRA's rule writing, compliance, and enforcement responsibilities. CBRA could employ a model, similar to the current approach in banking regulation, under which it would be solely responsible for these functions. However, given CBRA's scope of responsibilities, that structure would not likely be practical. CBRA could also employ, or in some instances be required to employ, a structure similar to the current futures and securities regime that relies on SROs for many aspects of regulatory implementation and oversight. Given the breadth and scope of CBRA's responsibilities, some aspect of self-regulation should form an important component of implementation. Given its significance and effectiveness, the current SRO model for futures and securities should be preserved. That model could be considered for other areas, or the structure could be flexible enough to allow for certain modifications, such as maintaining rule writing authority with CRBA,

²⁰⁹ See *supra* Section II.B; see also Coffee, *supra* note 7; William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 *Tul. L. Rev.* 1275, 1333–58 (2002) (arguing that particularly high standards should be applied to accountant gatekeepers); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 *B.U. L. Rev.* 301, 308–11 (2004); John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 *Colum. L. Rev.* 1293, 1300–02 (2003); Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 *Minn. L. Rev.* 323, 342–52 (2007); Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 *Iowa L. Rev.* 1035, 1078–80 (2003); Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 *Vill. L. Rev.* 1167, 1167–70 (2003); Sale, *supra* note 14, at 160–61; John C. Coffee, Jr., *The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and the Governance of Accounting* (Columbia Law & Econ. Working Paper No. 191, 2001), available at <http://ssrn.com/abstract=270944>.

²¹⁰ See *supra* Section I.B.

while relying on an SRO model for compliance and enforcement.²¹¹

The key rationale offered here for shifting enforcement to the SROs appears to be the “breadth and scope of CBRA’s responsibilities.” If workload is the problem, the logical answer would be to increase the staff and resources of the federal agency, not to shift responsibility from a public enforcer to a private one.

Other than workload and a vague claim about the need to achieve convergence,²¹² the Blueprint is devoid of a rationale for why the SROs should absorb enforcement or, more importantly, why they would be good at it. Given that fraud, or more properly, the lack thereof, is so important to the marketplace, the question is a serious one.²¹³ As Part III has emphasized, the recent experience of the United States with an unparalleled level of fraud only adds to the importance of making the right enforcement decision—and for the right reasons.²¹⁴

The Blueprint’s silence on this question does not imply that serious arguments could not be made in favor of greater reliance on SROs.²¹⁵ To consider these, let’s begin with an initial question: who are the SROs? The Blueprint defines them as including the exchanges and the self-regulatory bodies for brokers and dealers (now FINRA). Today, each exchange or market has its own set of rules and regulations with which listed companies must comply.²¹⁶

²¹¹ Blueprint, *supra* note 17, at 178–79.

²¹² *Id.* at 179.

²¹³ See *United States v. O’Hagan*, 521 U.S. 642, 658 (1997) (describing honest markets as “an animating purpose of the Exchange Act”).

²¹⁴ See *supra* Part III.

²¹⁵ These have been explored at length in various articles, many of which were published in the *University of Virginia Law Review*. See, e.g., Paul G. Mahoney, *The Exchange As Regulator*, 83 *Va. L. Rev.* 1453, 1475–500 (1997) (exploring three assumptions underlying the argument that government regulation is necessary over the financial markets and concluding that a return to self regulation would improve U.S. competition while not unduly harming investors); Kahan, *supra* note 173, at 1510–19 (1997) (analyzing potential problems with self-regulating exchanges and concluding that though Mahoney’s argument for a deregulated securities market may be ideal for countries just beginning securities regulation, it should not be adopted wholesale in the United States where the current system is stable and performing relatively well); Pritchard, *supra* note 179, at 982 (exploring role of exchanges as regulators).

²¹⁶ See, e.g., *NYSE Euronext Listed Company Manual* (2009), available at http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/nyse/1182508124422.html&displayPage=/lcm/lcm_section.html.

In 2007, the NASD was consolidated with the listed company regulation, enforcement, and arbitration functions of the New York Stock Exchange, resulting in FINRA. According to FINRA's website,

FINRA touches virtually every aspect of the securities business—from registering and educating industry participants to examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. It also performs market regulation under contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange.²¹⁷

Thus, it is fair to say that the key SROs are the exchanges, FINRA, and, as discussed earlier, arguably the PCAOB, which serves as the SRO for auditing firms.²¹⁸

Next, the more difficult and critical issue involves whether the SROs can be effective enforcers against their own listed companies.²¹⁹ The SRO listed company rules are not particularly textured. Instead, they tend to be of a check-the-box nature—i.e., classic “rules” with no hint of principles lurking beneath the surface. For example, although both NASDAQ and NYSE/Euronext require some committees of listed companies' boards to be composed solely of independent directors, the definitions of independence are based on narrow and highly specific financial criteria.²²⁰ More

²¹⁷ About the Financial Industry Regulatory Authority, <http://www.finra.org/AboutFINRA/index.htm> (last visited Mar. 8, 2009).

²¹⁸ See *supra* note 13; see also *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 537 F.3d 667, 669 (D.C. Cir. 2008) (upholding the constitutionality of the PCAOB against an attack that it violated the Appointments Clause of the Constitution).

²¹⁹ See *supra* notes 76–101 and accompanying text (pointing out that self-regulation involving the investment banks and the CSE provisions was a failure).

²²⁰ For discussions of the different definitions of independence in use today, see Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307*, 2004 *Mich. St. L. Rev.* 299, 301–03 (approving Sarbanes-Oxley's definition of independence); Usha Rodrigues, *The Fetishization of Independence*, 33 *J. Corp. L.* 447, 452–55 (2008); Note, *Beyond “Independent” Directors: A*

fulsome disclosure may be warranted, but the listing rules do not require it.

More important, exchanges are businesses. In theory, they have an interest in creating rules and listing standards to attract investors.²²¹ Attracting investors attracts listed companies.²²² As economic actors, then, exchanges should understand that market integrity is important in attracting business.²²³ Companies want to list on efficient markets where they are likely to attract investors.²²⁴ Again, in theory, these basic interests could, over time, lead the SROs to develop rules and regulations to prevent fictitious transactions and securities, as well as fraud and other types of market manipulation. Hopefully, the SROs would want to promulgate regulations that promote their own reputations and, thereby, garner business. The fact that today there are two highly competitive U.S. exchanges enhances this argument—competition should encourage the development of efficient regulations.²²⁵

Arguably, the exchanges may also have some advantages in rulemaking. They are close to the market and have informational advantages that the government does not have.²²⁶ They would certainly have the opportunity to develop regulations based on the information to which they have access and, in particular, with respect to how the markets work. Perhaps relying on this view of the SRO's advantages, the Blueprint urges that all SRO-proposed rules be self-certifying, rather than subject to the check and, arguably, balance, of government approval.²²⁷

Functional Approach to Board Independence, 119 Harv. L. Rev. 1553, 1554–60 (2006).

²²¹ See Mahoney, *supra* note 215, at 1454–55, 1458. There is some historical support for this proposition. Exchanges were involved in regulating their listed companies in 1933 and 1934 and the regulations then did not differ significantly from those adopted with the 1933 and 1934 Acts. See *id.* at 1459–62, 1465–69.

²²² *Id.* at 1454–55, 1458.

²²³ Pritchard, *supra* note 179, at 963.

²²⁴ *Id.* (noting that exchanges provide liquidity to listed companies).

²²⁵ In today's world, although the exchanges and markets have their own listing standards, FINRA now occupies the enforcement field for both NASDAQ and NYSE/Euronext. Thus, the competition argument is debatable for enforcement purposes. See *id.* at 976–81.

²²⁶ See Mahoney, *supra* note 215, at 1498 (stating that the benefits of allowing the exchanges to do the rulemaking outweigh the drawbacks because of the exchanges' superior knowledge about investors).

²²⁷ Blueprint, *supra* note 17, at 116.

These are fairly straightforward economic arguments that have been made many times before. But there are complications. For example, the arguments for why exchanges and SROs make superior regulators sound much like the arguments that used to be made for why gatekeepers never fail. Indeed, over time, the more sophisticated proponents of SRO regulation have come to place less emphasis on the investor-protection side of the SROs' regulatory function and more on their need to attract listings.²²⁸ Further, today, even strong advocates of eliminating some aspects of SEC rulemaking functions and private class actions continue to stress public enforcement provisions.²²⁹

Perhaps the most important complication is that both the NYSE/Euronext and NASDAQ are now public companies. Public companies face issues that complicate their decision-making in ways that arguably make them ineffective compliers, let alone regulators. Now add to that, under the Blueprint's scheme, that they would truly be self-regulating. They would set regulations, and enforce them, for themselves and for their listed companies. The conflict of interest is patent and is akin to the old adage of the "fox guarding the henhouse."

In addition, the economic arguments in favor of having the SROs take on these responsibilities rely significantly on reputation and market forces. Yet, these factors may be generally less effective than assumed. As Marcel Kahan has argued, exchanges have limited incentives to expose "bad" information about their listed companies.²³⁰ Information that casts the exchange in a negative light will harm its ability to attract investors and other companies.²³¹ If they have little interest in disclosing their own problems, they will presumably have little incentive to ferret information out in

²²⁸ See Craig Pirrong, *A Theory of Financial Exchange Organization*, 43 *J.L. & Econ.* 437, 438 (2000) (noting that when there is near perfect competition in the supply of financial transaction services, "exchanges adopt efficient rules and governance structures because they will not survive otherwise."); Pritchard, *supra* note 179, at 964.

²²⁹ See Mahoney, *supra* note 215, at 1491-96; Pritchard, *supra* note 179, at 1017-18.

²³⁰ Kahan, *supra* note 173, at 1517-18 (arguing that stock exchanges have an interest in portraying a favorable image to the investing public and therefore have little incentive to search for and disclose violations of companies listed on their exchanges).

²³¹ See *id.*

the first place.²³² Thus, the reputational and market forces cut both ways here—particularly with respect to enforcement.

Exchange-based enforcement may not be effective for other reasons as well. Listing is voluntary. Listed companies who are dissatisfied have choices (indeed that is part of the rationale for the Blueprint's recommendations). An obvious choice is to select a different exchange and with it a different regulatory body, including a non U.S. exchange and a non U.S. regulator. This fear of the foreign migration of listed companies may well create a disincentive for the exchanges, which are public companies themselves, to enforce their regulations aggressively. Yet, the social loss from "soft" regulation may exceed the gains from attracting more listings. Investors may lose precisely as the investment banks gain.²³³

In addition, because the SEC regulates many aspects of securities law, not just those concerning the listed companies themselves, delegation to SROs implicates the interests of third parties. To begin with an obvious fact, the SEC has the power to regulate and sanction acts beyond those of listed companies and members.²³⁴ For example, in 2007, the SEC preempted the exchanges from adopting an "uptick" rule to regulate short selling, and in 2008 the SEC proposed regulations on "naked short selling." Such regulations focus on traders who are not necessarily exchange members (for example, institutional investors, hedge funds, etc.). Today, the exchanges no longer have effective power to control these aspects of securities regulation. It seems a fair question to ask whether it would be desirable to delegate power over these third parties to a public company that is being regulated by itself. Arguably, it could have an incentive to prevent any sort of short selling or speculative trading at all. The very concept of delegating such a dramatic level of responsibility to a public company, with a board focused on its

²³² *Id.*

²³³ As Professor Donald Langevoort has put it, "less business for Wall Street institutions . . . is not necessarily a bad thing for investors." See Donald C. Langevoort, *U.S. Securities Regulation and Global Competition*, 3 *Va. L. & Bus. Rev.* 191, 195 (2008) (citing Coffee, *supra* note 57, at 237–38). The basic point is that gains to the market professionals from more transactions could be offset by a higher cost of capital, and to this extent there is a "basic conflict . . . between the interests of the public and those of the professionals and intermediaries active in the securities markets." Coffee, *supra* note 57, at 311.

²³⁴ See Mahoney, *supra* note 215, at 1497–98.

own earnings and compensation, raises questions about outsourcing that deserve very serious discussion. The Blueprint, however, ignores these issues entirely.

Finally, today, the exchanges target their enforcement efforts less at public companies and more on broker-dealers. FINRA, the combined enforcement body for NYSE/Euronext and NASDAQ, is not, therefore, a “complete” enforcer. Instead, it tends to occupy the broker-dealer field, leaving the other matters to the SEC. Arguably, then, the SEC and FINRA have reached an efficient division of labor that allows for specialization. Shifting the responsibility to the SROs eliminates this division of labor and puts industry in charge of itself.

In sum, without any rationale other than CBRA’s workload, the Blueprint suggests broad elimination of SEC and state-level enforcement powers in favor of letting the regulated enforce against themselves. Yet, the exchanges currently rely upon governmental assistance and the government’s power to deter fraud.²³⁵ Unquestionably, the exchanges would like the SEC to listen to their point of view more attentively, and probably the SEC should be pushed to expedite its review of proposed SRO rules (which has been a long-standing source of tension between the SROs and the SEC, but which it has promised to do). But regulations alone do not make a sufficient anti-fraud regime. Instead, fraud-prevention requires deterrence. Deterrence requires detection, and detection requires detectives with the incentive to achieve outcomes. The current system is one of tripartite enforcement—the exchanges do some, the SEC does some,²³⁶ and the states provide valuable backup. The backup is key, because it provides a failsafe control against regulatory capture. Although the exchanges may be able to play some role here, hardcore fraud requires the intervention of an outsider.²³⁷ The Blueprint, however, would replace the outsider with self-regulating insiders.

²³⁵ See *id.* at 1499; Pritchard, *supra* note 179, at 976–77.

²³⁶ See Pritchard, *supra* note 179, at 976–77.

²³⁷ See *id.*

V. CONSOLIDATION AND COORDINATION

Although we have been, to this point, critical of the Blueprint for its unsupported faith in self-regulation and the natural superiority of principles over rules, those aspects of the Blueprint are less important than its structural proposals. Its core contribution is to call forcefully for consolidation within a system of financial regulation that is fragmented to the point of Balkanization. Moreover, the Blueprint also makes an astute judgment in preferring a “twin peaks” or multiple agency regulatory structure that places consumer protection, business conduct, and disclosure regulation under one regulatory authority and traditional prudential financial oversight (i.e., “safety and soundness” regulation) under another.²³⁸ In effect, the Treasury Department has followed Australia, rather than the United Kingdom—and wisely so. One unified regulator, which is the U.K. model, places too many responsibilities under one regulator, thereby masking the conflicts that can arise between consumer protection and maintenance of bank solvency and soundness.

But if one accepts the superiority of the “twin peaks” model, that still leaves open the question of how regulatory authority should be allocated between the two agencies. Specifically, assume that the Blueprint is influential and, acting upon it, some future Administration resolves to pursue a “twin peaks” model that assigns the SEC authority over disclosure, business conduct, and consumer protection, but gives some amalgam of the OCC and the Federal Reserve authority over the safety and soundness of financial institutions. What responsibilities might still migrate from one agency to the other? In Section A below, we recommend that “prudential” regulatory authority over all financial institutions be consolidated in the Federal Reserve/OCC successor. As the agency which ultimately must fund bailouts for troubled financial institutions, it has the best incentives to protect bank safety and sound-

²³⁸ The Blueprint actually proposes a tripartite model with a “market stability” regulator, a “prudential financial” regulator, and a “business conduct” regulator. See Blueprint, *supra* note 17, at 13–14. Effectively, once one translates these terms into the current organizational environment, this means that the Federal Reserve would not be consolidated with the Office of the Controller of the Currency and that the SEC would not be merged into a unified financial regulator. We do not address the specific form of consolidation that should occur among banking regulators.

ness. As a practical matter, this means that the SEC would largely surrender its authority to administer its “net capital rule” and would instead look to the Federal Reserve to restrict excessive leverage at investment banks, mutual funds, and hedge funds.

Section B addresses the problem of enforcement competition. Although we have argued that state regulators should be encouraged and not preempted from securities fraud enforcement, we recognize that a point can be reached where one state regulator could take action under anti-fraud rules that did conflict with important federal regulatory policies. Still, rather than preempt all state regulators *ex ante* because of this potential conflict, we propose an alternative, and more limited, policy that would apply on an *ex post* basis only.

A. Prudential Financial Regulation: Not the SEC's Job

The SEC has administered its net capital rules from the agency's outset.²³⁹ Why should it abandon this authority to banking regulators? Our answer is twofold: (1) times have changed, and (2) banking regulators have the comparative advantage because they focus on precisely these issues of risk, leverage, safety, and soundness over a broad range of financial institutions. Also, because it would have exclusive and highly visible responsibility for capital adequacy regulation, the Federal Reserve should prove less subject to capture than an agency, such as the SEC, for which prudential supervision has been only a secondary responsibility.²⁴⁰

Times have changed in several critical respects. First, as earlier discussed, the major investment banks have failed, merged with commercial banks, or reconstituted themselves as bank holding

²³⁹ Federal net capital standards for broker dealers have been administered by the SEC since its inception in 1934, and the precursor of the current net capital rules, which are predicated on Section 15(c)(3) of the Securities Exchange Act of 1934, dates back to 1938. See Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 853 (4th ed. 2004). Rule 15c3-1 dates back to 1975.

²⁴⁰ The literature on the prospects for “capture” of administrative agencies is voluminous, but there are strong arguments that agencies with broader jurisdiction are less subject to capture than “single purpose” agencies. See Jonathan R. Macey, *Organizational Design and the Political Control of Administrative Agencies*, 8 *J.L. Econ. & Org.* 93 (1992). The SEC is, of course, closer to a “special purpose” agency than the Federal Reserve, which, as proposed, would monitor the safety and soundness of all major financial institutions.

companies. Today, most large broker-dealers are part of a larger financial conglomerate, and their risk management activities, capital adequacy, and operational status can be meaningfully understood only on a consolidated, entity-wide basis. Indeed, the SEC recognized this fact in 2004 when it put into place its “consolidated supervised entity” (“CSE”) framework, which allowed broker-dealers and their holding companies to elect to be subject to SEC supervision with respect to capital adequacy on a group-wide basis voluntarily.²⁴¹ The SEC recently abandoned the CSE program, conceding its failure,²⁴² and others have viewed it even more suspiciously as an instance of regulatory capture.²⁴³

The real issue for the future involves not investment banks, but hedge funds and insurance companies, which are not seriously regulated at the federal level today, but are similarly capable of destabilizing the financial system (as AIG has surely proved). We propose that the regulatory consolidation give the Federal Reserve authority to monitor and restrict the leverage of all financial institutions that are “too big to fail.”

Second, the issue that most threatens the solvency of financial institutions involves the explosive growth of over-the-counter derivatives, and in particular credit default swaps.²⁴⁴ Bear Stearns was bailed out by the Federal Reserve, not because it was too big to fail, but because it was too entangled to fail. Much like AIG, it had issued billions of dollars worth of credit default swaps, and its failure could conceivably have set off a cascade of falling financial dominoes.

But if the growth of derivatives is the key weakness, the SEC is poorly positioned to address or resolve this problem. Under Section 3A of the Securities Exchange Act, the SEC is broadly denied

²⁴¹ See Alternative Net Capital Requirement for Broker-Dealers That Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34,428 (June 21, 2004) (to be codified at 17 C.F.R. pts. 200 & 240).

²⁴² Press Release, Sec. & Exch. Comm’n, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm> (quoting Chairman Cox as saying that “voluntary regulation does not work”).

²⁴³ See, e.g., Labaton, *supra* note 83, at A1.

²⁴⁴ See Press Release, Int’l Swaps and Derivatives Ass’n, ISDA Mid-Year 2008 Market Survey Shows Credit Derivatives at \$54.6 Trillion (Sept. 24, 2008), available at <http://www.isda.org/press/press092508.html> (noting that the annual growth rate for credit derivatives from mid-2007 to mid-2008 was 20 percent).

authority over swap agreements in sweeping language that even denies the SEC the ability to “recommend” or “suggest” registration of derivatives²⁴⁵ or to impose “reporting or recordkeeping requirements.”²⁴⁶ In addition, the SEC and the CFTC have regularly engaged in a bureaucratic turf war for jurisdiction over the OTC derivatives market. Absent a merger, neither would likely cede jurisdiction to the other. In contrast, giving the Federal Reserve jurisdiction over capital adequacy issues would not diminish the authority of either the SEC or CFTC. Further, the Federal Reserve has a long-standing consistent position of steadily seeking the establishment of an industry-wide clearing house for the trading of over-the-counter derivatives.²⁴⁷

Apart from political considerations, banking regulators have the natural comparative advantage in this area. Capital adequacy regulation, including the supervision of risk management, is the core business of banking regulators. In the post-Basel II environment, their personnel are highly trained in the latest techniques. The SEC, however, is fundamentally a disclosure regulator. As a result, it is questionable whether it could or should have a sufficient number of trained personnel to engage in in-depth oversight of capital adequacy. Inherently too, the SEC will always have a “bottom up” perspective, looking through the regulated broker-dealer to its parent financial holding company, whereas banking regulators have the superior “top down” perspective.

For the Federal Reserve, capital adequacy and the safety and soundness of financial institutions would always be a high priority issue, for which they would have to accept the political responsibility if a major insolvency occurred. In contrast, it is open to question whether capital adequacy regulation would ever become a major priority for the SEC. By culture and philosophy, the SEC is a dis-

²⁴⁵ See Securities Exchange Act of 1934 § 3A(b)(2), 15 U.S.C. § 78c-1(b)(2) (2006).

²⁴⁶ See Securities Exchange Act of 1934 § 3A(b)(3), 15 U.S.C. § 78c-1(b)(3) (2006).

²⁴⁷ See Joanne Morrison, *Fed's Kohn Sees CDS Clearinghouse Risks, Benefits*, Reuters, June 19, 2008, <http://www.reuters.com/article/gc06/idUSN1962224820080619> (discussing role of New York Fed in establishing clearinghouse); Aline van Duyn et al., *Plans for Central Clearing House for Derivatives*, FT.com, July 31, 2008, <http://www.ft.com/cms/s/0/5c6eb2e4-5f37-11dd-91c0-000077b07658.html> (noting that by the end of 2008, there should be a central clearing house established for the credit derivatives market).

closure regulator, whose concerns with risk and leverage are normally satisfied once full disclosure is made.

For the future, it seems obvious that financial regulators will need to restrict leverage and risky trading practices, both at investment banks and other financial institutions. The agency best suited to accomplish this task is not the SEC. Banking regulators have better skilled personnel (and more of them), better information (acquired from their regulatory oversight of commercial banks and other financial institutions), and greater power over their regulated institutions. This does not mean that the SEC should be stripped of all power in this regard, and it may sensibly remain the front-line regulator that supervised the financial safety and soundness of smaller broker-dealers. But the primary responsibility for determining capital adequacy at major financial institutions that are "too big to fail" should be given to one unified prudential regulator, as the body with the greater experience and superior resources.

We recognize that under the "Twin Peaks" model that we are proposing, conflicts can arise between the perspectives of the two regulators. Indeed, the cultures and priorities of securities regulators and banking regulators differ dramatically. Instinctively, securities regulators favor full disclosure and transparency, while banking regulators fear that adverse information may alarm or panic investors and depositors, thereby causing a "run on the bank." Sometimes, these fears can produce a conspiracy of silence between the banking regulator and its regulated firms, as both fear that full disclosure will cause investors to withdraw or withhold capital. For exactly this reason, we believe that the regulator assigned prudential oversight responsibilities over financial institutions that are "too big to fail" should not also have authority to curtail disclosure or consumer protection policies.

But there are areas where such a systemic risk regulator may have the final word. Take, for example, a subject matter such as short selling. To a systemic risk regulator, short selling, particularly in times of market stress, may threaten the stability of the financial institutions that are the targets of the short sellers' attack. To the anti-fraud regulator, short selling may seem a desirable corrective to the excessive optimism that emanates from corporate manage-

ment. How should this tension be resolved?²⁴⁸ We doubt that this type of conflict necessitates the creation of a financial “czar” able to resolve deadlocks by fiat. That would threaten the independence of both agencies. Still, rules that curb short selling probably are more closely related to the concerns of the systemic risk regulator than those of the investor protection agency. Nonetheless, issues of this sort have long been mediated by the President’s Working Group on Financial Markets, and, absent stronger evidence of unmanageable deadlocks, we counsel caution before any financial czar is created.

B. State/Federal Relationships in a Competitive Environment

We have earlier argued that competition among enforcers is healthy and has filled gaps in securities enforcement. But limits may need to be placed on this competition. Consider a circumstance that briefly arose during New York Attorney General Spitzer’s settlement negotiations with Merrill Lynch and other investment banks over conflicts of interest surrounding securities analysts. For a time, Mr. Spitzer was convinced that the only appropriate remedy was a prophylactic rule under which investment banks that underwrote securities would be barred from employing securities analysts. The investment banks would therefore be required to spin off or sell their research divisions to firms that did not underwrite securities. Although the New York Attorney General was basically armed only with an antifraud statute, that statute was liberally phrased and carried criminal penalties.²⁴⁹ The pressure

²⁴⁸ This example was suggested to us by Professor Donald Langevoort. As we see it, a prudential regulator that was instructed to monitor systemic risk could make a determination that “naked” short selling needed to be curbed or could decide to reimpose the traditional “tick” test that limited short selling to times when the market price was increasing, because these were judgments about the overall impact of the practice on systemic risk. But the SEC would remain the anti-fraud enforcer with respect to issues of market manipulation. Neither role necessarily interferes with the critical functions of the other agency, but consultation should be necessary before either acts.

²⁴⁹ For an overview of New York’s Martin Act, see Coffee, Seligman & Sale, *supra* note 55, at 1277–78 (discussing broad reach of Martin Act and Spitzer’s use of it); see also Mike McIntire, *Two Views of a Rising Star: Populist Warrior or Reckless Foe of Big Business*, *N.Y. Times*, Oct. 15, 2006, at 35 (describing how Spitzer used the Martin Act to force large Wall Street firms such as Merrill Lynch to disclose conflicts of interest).

of high potential liability can coerce a defendant to agree to virtually any non-pecuniary terms that reduce its financial or criminal liability. Here, the financial industry's fears are not without some basis in fact.

To be sure, the point here is not the dubious merits of Mr. Spitzer's proposed prophylactic rule regarding securities analysts (which ultimately the New York Attorney General abandoned as ill-considered). Rather, it is that one state jurisdiction, if adamant, may be able to impose terms and conditions that adversely impact the national market. If the SEC did not want to compel the spin off of all securities research and New York State did, the SEC's judgment should control. To ensure that the SEC retains this power, we would favor legislation authorizing the SEC to take action *ex post* to invalidate any rule, regulation, or order made by a state securities regulator, or any provision in a settlement between state regulators and defendants, that in the SEC's judgment unreasonably restrained competition, interfered with fair and orderly markets, impeded the national market system, or was otherwise contrary to the public interest or the protection of investors.²⁵⁰ This power is broad, but would not be unlimited. Most importantly, it would be an *ex post* power, not a general prohibition on rulemaking or litigation. The SEC would, however, be required to notify the state regulator and the market of its rationale for deeming the action contrary to the public interest or the protection of investors.

²⁵⁰ Of course, there would have to be a time limit on the application of any such power to veto or abrogate state rules and settlements. For example, it may extend for ninety days after the SEC receives formal notice from the state regulator of its action, which would incentivize the state regulator to provide early notice to the SEC and possibly to engage in pre-settlement discussions with it. Where a settlement's provisions were upset, both sides would have the right to renegotiate or to continue the litigation without prejudice. The concept of such a federal power over state regulators is not fundamentally different from the power that the SEC today has over the SROs to amend, repeal or abrogate their rules. See Securities Exchange Act of 1934 § 19(c), 15 U.S.C. § 78s(c) (2006) (granting SEC authority to "abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization . . . or otherwise in furtherance of the purposes of this chapter"). We do not address the standard for judicial review of the SEC's decisions in this regard. But see *Bus. Roundtable v. Sec. & Exch. Comm'n*, 905 F.2d 406, 408 (D.C. Cir. 1990) (discussing whether deference to the SEC is appropriate).

The logic of this proposal is that the SEC is politically accountable and should remain so. Were the SEC to take action invalidating a rule or settlement reached by state regulators, it would have to bear political costs, because it would be subject to political attack and criticism—and properly so. State Attorneys General are adept, possibly more adept than the SEC, at mobilizing public opinion, and the press would predictably focus on the case. As a result, Congressional oversight of the SEC's actions would be highly likely. Such oversight is a powerful check on any overreaching.

More important, under this provision, the SEC could not place some topic or issue wholly off limits to state regulators, in effect preempting state regulation. This broader preemption is what the Blueprint proposes and what we have earlier criticized. Under our proposal, the SEC could preempt only specific rules, regulations, or settlements—and only with a full public explanation from the SEC as to why the action invalidated was contrary to the public interest or the protection of investors. We submit that the SEC would use this power only sparingly and that such an *ex post* power responds adequately to the danger that a single state might take action on its own that adversely impacted competition or the national market system.

CONCLUSION

What should we learn from this crisis?

First, financial institutions are fragile. Because they rely on short-term liabilities to finance their holding of longer-term illiquid assets, they are inherently likely to face liquidity crises in times of market stress.

Second, the incentives for financial institutions to increase leverage in order to enhance profitability are strong. This cycle is likely to repeat itself, at least so long as financial managers remain incentivized to accept high risk and “to keep dancing as long as the music is playing.”²⁵¹

²⁵¹ This is, of course, a paraphrase of Mr. Prince's quotation. See *supra* note 103, and accompanying text.

Third, in a bubbly market, it is easy to rationalize economizing on due diligence and professional standards. But the long-term costs are high.

Fourth, simple rules typically work better than complex ones. Although a prophylactic rule that places a ceiling on leverage (as the SEC's standard net capital rule did) has its costs, it is capable of effective implementation, while a more optimal rule (in terms of its theoretical design) may not be.

All these conclusions converge to imply that excessive deregulation was a principal cause of the 2008 financial crisis. Against this backdrop, we believe that the Blueprint's proposal to confine the U.S. securities regulator to the promulgation of broad principles and leave it to the SROs to issue specific rules implementing those principles, while also preempting state enforcers, is precisely the wrong prescription. At most, we propose the SEC be given a more limited ex post power to restrain state regulators, but not to preempt them.

All said, the Blueprint still makes an important contribution in calling for the consolidation of financial regulators and by favoring the "twin peaks" model of separating the consumer protection regulator from the "prudential" or "safety and soundness" regulator. To limit excessive leverage and risky trading practices, one must give a greater role to the prudential regulator. Precisely because "prudential" regulation of leverage and risk requires the regulator to go beyond disclosure and reach paternalistic judgments about what level of risk is unsound, we doubt that the SEC is ideally suited to play this role. Neither its culture nor its expertise incline it to go beyond its normal mandate of ensuring full disclosure. In contrast, banking regulators are necessarily judgmental and, to a degree, paternalistic. From their perspective, they can and should consider all financial institutions, including investment banks, from a common perspective. At such a task, we believe the Federal Reserve or a similar agency has the comparative advantage, is less exposed to capture, and can outperform the SEC. But such an agency will necessarily be more committed to maintenance of bank solvency than to investor protection, and thus it should not have jurisdiction to override the SEC's authority with regard to disclosure and investor protection.

Important as the issues we have discussed are, we must close with the nagging sense that a “twin peaks” model will require a period of experimentation and adjustment. In all likelihood, these issues will still be the subject of debate when the Virginia Law Review in due course convenes its “100th Anniversary of the SEC Symposium.” Law reform is a marathon, not a sprint.