Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation

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INTRODUCTION

It's as predictable as the swallows' return to Capistrano. At the outset of each new Administration, a Presidential Task Force proposes a restructuring of the federal administrative agencies. New developments in rapidly evolving markets, it is argued, require a consolidation of agencies to generate a broader perspective, to create a "level playing field," and to end the possibility of a "race to the bottom" (to the extent that market participants can opt for one regulatory system over another). The proposal draws little overt criticism, but turf-conscious agencies quietly mobilize their constituencies to oppose the reform. The first sign of trouble surfaces when the various congressional oversight committees express their misgivings and signal their reluctance to surrender authority over the affected agencies. Hearings are scheduled and delayed—and delayed. Eventually, by mid-Administration, the White House is too busy pushing its core legislative agenda and/or surviving the inevitable scandal to risk alienating important members of Congress over a "good government" issue with little political sex appeal. As a result, the status quo survives.

Perhaps this scenario sounds too cynical. But each recent Administration has repeated it. The early Clinton administration has paralleled the experience of the early Reagan administration. At the outset of the Reagan administration, an interagency Task Group on Regulation of Financial Services, chaired by then-Vice President George Bush, sought to consolidate federal regulatory authority over financial services firms, both to reduce regulatory overlap and to mediate conflicts then developing between the Securities and Exchange Commission (SEC) and federal banking
authorities. In the end, no consolidation resulted, and only proposals for redistribution of authority were made. Already in the Clinton administration, an ambitious plan to consolidate several federal banking agencies into a proposed Federal Banking Commission has been quietly shelved in the face of active opposition from the Federal Reserve Board.

To the extent this pattern persists, interagency turf wars will continue, the playing field will remain unlevel, and "races to the bottom" (or wherever) will continue. Is this bad? Not necessarily. Economists describe these same circumstances as exactly those in which a healthy "regulatory competition" flourishes and view such a state of affairs as vastly preferable to the system of "monopolistic" regulation, which in their view would arise from the consolidation of agencies.

Although the theory of regulatory competition has most commonly been applied to the interstate competition for corporate charters, and to the dual banking system, it applies as well in principle to struggles for jurisdiction and clout among federal agencies. Within the arena of federal financial regulation, this theory has three very counter-intuitive implications. First, the theory challenges the conventional wisdom that merging long competing federal agencies (such as the SEC and the Commodities Futures Trading Commission (CFTC)) that each regulate some (but not all) participants or transactions within a single market will result in more efficient and consistent regulation. To the contrary, proponents of regulatory competition argue that regulatory consolidation will result in costly overregulation.

Second, the theory provides probably the only theoretically serious (but still highly debatable) justification for our contemporary dual banking system under which financial institutions can effectively opt for either state or federal regulation.

Third, the theory tends to undercut the seemingly strong case for harmonization of international legal rules applicable to financial institutions, as the fact that a broker-dealer might flee to an unregulated (or, allegedly,

2. Kane, supra note 1, at 373.
4. See supra note 1 and infra notes 24, 27 & 29.
5. See infra notes 36-38.
7. See Scott, supra note 6; Butler & Macey, supra note 6.
underregulated) foreign jurisdiction becomes, under this theory, an essential protection against overregulation. Proponents of this view tend to view skeptically any form of international regulatory accord, even on matters such as risk-based capital standards for banks, where the prospect of serious externalities seems obvious.

The merits of the theory of regulatory competition have special contemporary relevance at a time when several carefully developed proposals have been made to consolidate the federal regulatory agencies having jurisdiction over most financial institutions. Probably the best known of these proposals is an ingenious and sophisticated plan advanced by the Chicago Mercantile Exchange (CME), which proposes to consolidate not only the CFTC and the SEC, but also the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the Securities Investor Protection Corporation (SIPC) and also portions of the Department of Labor and the Federal Reserve Board into one giant mega-regulator. Similarly, although the Clinton administration has at least temporarily shelved its proposal for a consolidated Federal Banking Commission, such a proposal seems likely to resurface—phoenix-like from the ashes—either later in this Administration or in some future Administration. Finally, with the CFTC again facing reauthorization (after its last reauthorization was granted on the condition that a joint study be made of the need for a unified regulatory agency), it is not surprising to see new proposals again surface to merge the SEC and the CFTC. As they do, the debate over the competing merits of regulatory competition versus regulatory consolidation again moves to the legislative front burner.

Since the Brady Report, policy planners have proceeded quickly from the premise that the various markets in securities, commodities, and hybrid instruments constitute "one market" to the policy conclusion that there-


10. See Bradsher, Bank Regulation Bid, supra note 3, at 35.


12. Report of the Presidential Task Force on Market Mechanisms (1988). The Brady Report recommended a single regulatory agency that would have oversight responsibility over the SEC, the CFTC, and other agencies. It proposed that this oversight role be given to the Federal Reserve Board. Id. at 59-63.
fore they require one regulator. The premise is clearly correct, but that the policy conclusion follows is more debatable. Does "one market" really require "one regulator?" To approach this issue cautiously, this Article will use as its stalking horse the CME's proposal to consolidate futures, securities, and banking regulation in a new overarching agency. Obviously, the theory of regulatory competition would dispute the wisdom of this proposal because it produces a regulatory monopoly. This Article, however, is less interested in the fact that a theoretical basis for objection exists to a proposal than in testing the richness and validity of that theory against the complex institutional reality that it purports to assess. Does the theory of regulatory competition provide an appropriate model for policy planning or only a set of intellectual blinders?

Initially, this Article will re-examine the history of the SEC's and the CFTC's long-standing rivalry to evaluate the extent to which the theory of regulatory competition accurately assesses the costs and benefits of regulatory overlap. Then, it will turn to the case for regulatory consolidation and examine three distinct groups of arguments for consolidation that the theory of regulatory competition seems to ignore: (i) public choice arguments, (ii) regulatory market failure arguments, and (iii) economy of scope and scale arguments. Some of these arguments are familiar ones, but they are by no means encompassed by the traditional (indeed, hackneyed) contention that regulatory competition will produce a "race to the bottom." In fact, the more important arguments in favor of consolidation are quite distinct from this thesis and involve more specific claims about externalities and the likelihood of regulatory capture.

Ultimately, this Article will argue that, at least within the increasingly competitive international environment, the gains from domestic regulatory competition are likely to be modest, while the costs of regulatory competition can be substantial and have been underrecognized. Although these costs are not inherent in the pure theory of regulatory competition, they are likely to be present in the more institutionally complex environments that actual policy planning must address. Still, this does not mean that regulatory consolidation is necessarily the appropriate answer. Clearly, it can stifle innovation and new product development. Checks and balances are needed, but such compromises are likely to be institutional, ad hoc ones. This Article proposes a possible compromise for the context of financial and market regulation in its final section.

THE CASE FOR COMPETITION

Since the Brady Report recommended that both the SEC and the CFTC be placed under the general oversight of the Federal Reserve Board, proposals to reallocate or consolidate authority between the SEC and the
CFTC have been common. In 1990, the White House proposed that the SEC be given jurisdiction over stock index futures, and early Senate drafts of the Market Reform Act of 1990 sought to coordinate the SEC and the CFTC jurisdiction along these lines. None of these proposals has gone far in Congress, where the House Agriculture Committee, in particular, has protected the jurisdiction of the CFTC zealously.

In this light, what is distinctive about the CME's proposal is its source: the proposal emanates from a body that has long feared regulatory consolidation—probably in the belief that its interests would be submerged in any combined agency by the greater size and clout of the securities industry and the likelihood that most of the senior regulatory staff would be SEC alumni. Yet, the CME's proposals are more sweeping than those made in the original Brady Report. The fact that a major market participant has called for consolidation by itself may reveal much: namely, that there are real costs imposed on the regulated parties by regulatory turf wars, which the theory of regulatory competition does not adequately recognize.

**THE CME'S PROPOSAL**

The CME's proposal was first partially unveiled by Jack Sandner, the CME's chairman, in October 1992, who offered as its principal justification that the current regulatory system "leads to pure gridlock in trying to deliver products to the user." The CME's proposal would consolidate in a single, cabinet-level department a host of existing agencies in addition to the SEC and the CFTC: the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the Securities Investor Protection Corporation (SIPC), the Pension Benefit Guaranty Corporation (PBGC), and certain functions of the Federal Reserve Board and the Department of Labor. In its own words, the proposal seeks, above all, a level playing field—namely, a functional system of regulation "so that financial products, services and markets delivering similar benefits and risks can be subjected to substantially equivalent regulation and so that economic competition, rather than jurisdictional barriers or differences in supervision, can determine which products, services and markets succeed in the market-

17. Glickman Calls for New Agency to Regulate Futures and Securities, supra note 16.
19. Chicago Mercantile Exchange, supra note 9, at 2.
place." The new agency would be known as the Federal Financial Regulatory Service (FFRS or Agency) and would be administered by a board of nine commissioners, each appointed by the President and confirmed by the Senate, with the chairperson having cabinet-level rank. The Agency would, however, be radically decentralized with each of the nine commissioners being individually responsible for administration of a specified operating division of the FFRS. In this sense, the FFRS is less a single agency than a financial cabinet within which largely autonomous agency heads would collectively make financial policy. In short, this proposal's real goal (which is in no way disguised) is less merger of units than coordination of financial regulatory policies.

This becomes even clearer when one looks at the relatively close correspondence between most of the FFRS's divisions and existing federal agencies. The proposed Division of Prudential and Systemic Risk would be responsible for capital adequacy and "safety and soundness" regulation. Effectively, it would combine the OCC and the OTS with those components of the SEC and the CFTC that enforce "net capital" rules. The proposed Division of Investment Securities Markets would be "responsible for all trading in fungible non-offset instruments (debt and equity securities and other traditional and non-traditional securities other than options), for the stock exchanges, for the National Association of Securities Dealers (NASD), and for the professional entities ... registered in those markets"—in short, it would result in an SEC shorn of its jurisdiction over options. Correspondingly, a Division of Risk-Shifting Markets would closely resemble the current CFTC and would be "[r]esponsible for all trading in standardized offset instruments (whether overlying financial assets or obligations, foreign exchange, or agricultural or mineral commodities), for the futures and options exchanges, for the National Futures Association (NFA), and for the professional entities ... registered in those markets." Viewed narrowly then, this is a merger proposal in which the CFTC (or its re-named successor, the Division of Risk-Shifting Markets) wins jurisdiction over options and also gains authority over swaps and other hybrid instruments (which presumably would be considered "standardized offset instruments"). From this perspective, the CFTC loses nothing and wins turf from its traditional political rivals, the SEC and the International Swap Dealers Association (ISDA).

20. Id.
21. Id. at 4-5.
22. Id. at 5-6.
23. Id. at 5-12.
24. Id. at 8.
25. Id. at 9.
26. Id.
Still, although the proposed reallocation of authority would represent a major victory for Chicago (and the CFTC) in its long-running rivalry with both the SEC and the federal banking authorities, this proposal is not without cost to the CFTC (or the CME) and reflects more than wishful thinking on their part. To advance this proposal and thereby concede the need for fundamental reorganization of the financial markets costs the CFTC and the futures industry something: as realists, they must know that once the political process of structural reorganization is placed in motion, it gains a momentum of its own, and the end result is unpredictable. As the politically and economically weaker of the two contending forces, the CFTC (and the commodities futures industry) is at a disadvantage vis-a-vis the SEC (and the securities industry). Although the CFTC has shown it can successfully defend its turf by claiming that changes are not necessary, it is far less clear that it can win an aggressive war for the SEC's turf (i.e., the options market)—or even hold its own territory once it acknowledges that change is necessary.

Given these risks, the CME's willingness to reopen the battle suggests that the existing regulatory competition between the SEC and the CFTC has imposed costs on its industry that justify a proposal that carries with it at least one important advantage: the possibility that controversies can be resolved among its proposed nine commissioners at the board level.

THE THEORY OF REGULATORY COMPETITION

The theory of regulatory competition rests on three fundamental pillars: first, as Charles Tiebout demonstrated in 1956, at least under certain simplifying assumptions, interjurisdictional competition produces a Pareto-optimal outcome. The fear of exit causes local political units either to restrain themselves from adopting legislation that will produce outward migration or to seek the adoption of such legislation at the federal level (thereby generally precluding migration). This theory of regulatory competition is, however, subject to several important, and potentially problematic, theoretical qualifications: (i) it assumes that the consequences of each jurisdiction's legislation are felt only within that jurisdiction—in short, there are no positive or negative externalities; (ii) it assumes perfect mobility exists between jurisdictions; and (iii) it assumes that individuals or firms make the choice among jurisdictions or regulatory bodies based simply on which jurisdiction or agency offers the most efficient and least

costly regulatory regime. Ignored by this perspective is the possibility that the competing bodies (whether agencies or states) can engage in costly and retaliatory turf battles that impose a regulatory tax not only on those attempting to flee its authority, but also on persons always subject to the rival body. To assume away this possibility of strategic retaliatory action is to assume the proverbial can opener—that is, an assumption that is radically simplifying but totally alien to institutional reality.

The second pillar views the regulators themselves as behaving similarly to the managers of private firms and thus seeking to maximize the "value" of their agencies. To do so, they must compete with other regulatory agencies. Overlooked by this assumption are all the principal/agent problems that make corporate law, for example, interesting. The final pillar views regulators as simply representatives of their clientele. Under the strong version of this claim, regulatory agencies predictably tend to be "captured" by the interests they regulate. Once these three strands are interwoven, this very skeptical view of regulation assumes that regulators normally act in anti-competitive ways to deter new entrants into markets and to chill innovation that would be costly to established firms. But so long as no regulator obtains a monopolistic position, the disfavored can escape hostile regulation by migrating from one regulatory system to another. Ultimately, the fear of outward migration restrains the agency in the degree to which it seeks to restrain competition or protect favored firms. Obviously, the validity of this model, even on its own terms, depends on the absence of substantial exit costs—that is, regulatory migration must be possible at low cost in order to restrain inefficient regulation.

Proponents of this view have long argued that interstate competition for corporate charters resulted not in a race to the bottom (as Professor Cary argued), but in a race to the top. More recent scholarship, however, has viewed both positions as oversimplified, because of principal/

31. Tiebout, supra note 27, at 421.

32. Thus, it would oversimplify to call this assumption simply one of low exit costs. The costs involved here are borne not simply by those seeking to flee a jurisdiction or agency, but also by those always subject to the other jurisdiction or agency. The real assumption is that economic actors are often subject to the concurrent jurisdiction of two or more rival bodies (whether agencies, states, or nations). Economic actors often seek to change the relative degree to which they are subject to one agency versus another, but complete escape is rare. As such, the attempt to escape may provoke retaliation.

33. See Scott, supra note 6; Kane, supra note 8, at 34.


agent problems within the corporation that may allow managers sometimes (but not always) to pursue their own interests (rather than shareholder interests) in determining where to incorporate.  

But for precisely this reason the debate over the competition for corporate charters has little conceptual relevance to the question of whether regulatory competition enhances or erodes efficiency. In the corporate debate, the key issue is the significance and extent of the principal/agent problem: Will corporate managers race to incorporate in the jurisdiction that has the most protective anti-takeover statute or will the resulting decline in share value discipline them? There is less reason, however, to anticipate any corresponding principal/agent problem in financial managers' choices among regulatory regimes. That is, shareholders and managers have a common interest in avoiding burdensome regulation (even when its social benefits exceed its costs). Thus, the decision between the CFTC and the SEC, for example, presents little occasion for a conflict between shareholder and manager interests. Rather, the race-to-the-bottom scenario in this context depends upon the very different assertion that the individual agencies will excessively relax their rules in order to attract a greater regulatory clientele, and thereby increase the power and prestige of the agency.

Similarly, critics of our contemporary dual banking system who argue that it results in a "destructive ‘race to the bottom’" rely on a factor that again is largely absent from the competition among the federal agencies regulating financial institutions. Allowing firms to migrate among jurisdictions produces suboptimal regulation, they argue, because the FDIC does not charge for deposit insurance on an adequately risk-adjusted basis. Thus, depositors can be indifferent to the risk that the bank assumes and will happily accept higher interest for permitting the bank to engage in risky activities. In turn, shareholders will exploit this "moral hazard" problem by pressuring bank managers to migrate to the jurisdiction offering the laxest regulatory system. Although this interpretation helps explain the S&L crisis, the relevant point here involves the structure of this story. At bottom, it hinges on an externality: bank regulators, for some reason, permitted their client firms to externalize their costs on others (here, the taxpayers). Such a story does not fit the case of securities firms, however, because their brokerage customers do not finance the firm's activities (at least to any roughly similar extent). In short, the securities regulation story is more sanguine, but only because externalities are less present.

39. See Butler & Macey, supra note 6, at 715.
40. Id. at 712, 714.
41. Although SIPC does insure the customers of securities firms, the critical point is that these customers provide relatively little capital to these firms.
For these reasons, the theory of regulatory competition could have validity, and its prescriptions could desirably check excessive regulation in the securities and commodities fields, even if one accepts all the arguments that critics of interjurisdictional competition have made in the long-debated contexts of corporate chartering and banking regulation. In addition, the fact that the competing federal agencies would ultimately be responsible to the same Administration (which would suffer political and reputational losses if there was a scandal caused by lax regulation) suggests an additional restraining influence that makes the "race to the bottom" scenario even more unrealistic in this setting.

Finally, one can plausibly suggest instances in recent financial history where a monopolistic regulator might have inhibited innovation and competition but in which the limited and divided authority of multiple regulators permitted new products to be introduced. For example, when brokerage firms first introduced money management accounts in the early 1970s, the impact on commercial and savings banks, which were limited by Regulation Q in the maximum interest rates they could pay on deposits, was material and adverse. Had there then been a mega-regulator (even in the diluted form proposed by the CME), this threat to the banking industry might have led such a mega-regulator to bar (or restrict) money market accounts. Or, more recently, securities firms might have convinced a mega-regulator to bar stock index futures. In both cases, the outcome could have been anti-competitive, and financial innovation could have been stifled. But the absence of any such mega-regulator allowed efficient competition to proceed.

In short, an intuitively plausible case can be made that regulatory competition would yield benefits, without starting the "race to the bottom" thought by some to have resulted in other contexts (such as in the markets for corporate and bank charters). Nonetheless, a serious question remains whether the alleged competitive benefits of a system of multiple and overlapping regulators continue to be significant in a world in which securities and commodities markets are increasingly global in character. If, for example, stock index futures had not developed a decade ago and today financial entrepreneurs first sought to introduce them, the ability of any

42. 17 C.F.R. § 217.7.
44. Of course, the story does not end with the development of money market funds. Eventually, Regulation Q was rescinded, and, in an excess of deregulation, thrifts were freed from effective regulatory oversight. The resulting "moral hazard" problem caused (or, at least, contributed greatly) to the savings and loan debacle of the last decade. But it is overreaction to this problem to use it to justify a prophylactic rule that would have forbidden money market funds. Such funds have posed relatively few problems for regulators and triggered no domino-like chain of failures. Nonetheless, it is a characteristic response of regulators to identify product innovation and competitive pressure from new economic rivals as the "true" cause of a regulatory crisis.
monopolistic mega-regulator to bar them would be highly questionable. Even if the regulator had the legal authority to do so and exercised that authority to the hilt, entrepreneurs could simply introduce the new product off-shore (either on an over-the-counter basis or by marketing it on a foreign futures exchange). 45 Thus, given global markets, competition would persist even if financial regulators in the United States were consolidated into one monopolistic regulator. As a result, the dead-weight social loss from monopolistic regulation would be confined to markets and products where global competition is less of a force (for example, money market accounts probably could be effectively barred because the consumer market is a local one, as individual investors may not have realistic access to foreign brokerage firms). The bottom line then may be that, even if the theory of regulatory competition arguably has theoretical validity, the significance of the benefits it promises are being eclipsed by the rapid globalization of all major financial markets.

**THE COSTS AND BENEFITS OF REGULATORY COMPETITION: A CASE STUDY**

If one wished to design an experiment to test the theory of regulatory competition, the decade long rivalry between the CFTC and the SEC might seem to provide the perfect conditions for a natural experiment. Each agency has jurisdiction over products that can be engineered to be close financial substitutes for the others. But, as this section will argue, the costs and benefits of their competition have been more complex than the theory anticipates.

To begin with, the competition was actually a three-cornered contest, as the bank regulatory agencies, most notably the Federal Reserve Board (Fed) and the Treasury Department (Treasury), constituted a third player. This third player also participated on behalf of its client industry, which has a strong, if localized, interest in protecting swaps and related hybrid instruments from perceived overregulation by either agency. In overview, the relative success of the Fed and the Treasury in protecting their clientele (in particular, the swaps dealers) from SEC or CFTC regulation may be read as at least a partial affirmation of regulatory competition. But the experience of the CFTC and the SEC reveals significant—and perhaps greater—costs, as well.

45. If bureaucrats are immune from industry pressure, there is, of course, a loss to the U.S. Gross National Product, as trading moves off-shore. Particularly, in the case of new financial products, there is likely to be a substantial "first mover" advantage to the first market to trade a new product. Thus, later deregulation may not enable the domestic industry to recapture the volume of business that earlier moved off-shore.
The Banking Agencies versus the CFTC

As other commentators have recognized: "In any skirmish over regulatory turf, the Fed is strategically positioned. As financial regulator and stabilizer of last resort, the Fed's span of control far exceeds that of any other financial regulator."46 Although the Fed's interest in securities and commodity regulation is limited, it does serve as the protector of the banking industry, which has an intense concern that it not be regulated by a regulator that is in turn dominated by (or at least loyal to) the securities and commodities industries.

Initially, in 1974, the Fed and the Treasury secured a broad exemption for hybrid instruments from the coverage of the Commodity Exchange Act (CEA). Known popularly as the "Treasury Amendment," it provides that nothing in the CEA shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, re-purchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.47

Although the scope of this exemption was (and is) ambiguous, its core intent seems clear: to protect over-the-counter trading in hybrid instruments against being deemed futures contracts. At the time, the hybrid instruments most vulnerable to such an interpretation were Government National Mortgage Association (GNMA) forward contracts. These contracts evidence an interest in a pool of government underwritten residential mortgages, and banks are heavily involved in the packaging and trading of such pooled contracts. In Abrams v. Oppenheimer Government Securities, Inc.,48 the United States Court of Appeals for the Seventh Circuit looked to this legislative history and found such GNMA contracts to constitute forward contracts rather than futures.49 Although the GNMA contracts functionally resembled futures contracts in several respects, the decision chiefly relied on the following facts: (i) the contracts were individually negotiated and non-standardized,50 (ii) the purchasers of these contracts often took actual delivery of the underlying commodity,51 and, most important, (iii) the contracts were not traded on a contracts market.52 Although Abrams seemed consistent with the legislative history of the Treasury

46. Kane, supra note 1, at 377.
48. 737 F.2d 582 (7th Cir. 1984).
49. Id. at 584.
50. Id. at 590.
51. Id. at 591.
52. Id. at 590-91.
Amendment, the CFTC issued a Statutory Interpretation and Request for Comments within eighteen months of the Abrams decision that sought to narrow the decision's broad reading of the Treasury Amendment. This interpretation broadly posited that off-exchange trading in financial instruments only came within the Treasury Amendment when the participants were all "sophisticated and informed institutional participants."

Not only was this narrow interpretation aggressive in light of Abrams' reading of the Treasury Amendment, but it clearly and intentionally sought to subject to the CFTC's jurisdiction a long-established market in foreign currency trading, in which wealthy individuals were major participants. Had the CFTC persisted in this position, foreign currency trading would have been limited to the futures and options exchanges, and the over-the-counter market (in which banks participate heavily) would have been effectively shut down. Predictably, both the Fed and the Treasury protested, and in time the CFTC relented.

The banking agencies won a second important victory in the Futures Trading Practices Act of 1992. For some time, swap dealers had feared that they were likely to be caught in the middle of an increasingly acrimonious jurisdictional war between the CFTC and the SEC. Moreover, faced with increased competition from the over-the-counter market, the Chicago futures exchanges had long sought to subject their competitors to CFTC regulation. Consistently, spokespersons for the Federal Reserve Board had opposed subjecting swaps and similar hybrids to the CEA.

The Fed's opportunity to use its influence on behalf of its clientele (basically, banks and swap dealers) came in 1992 when the CFTC was required to seek reauthorization. At this sensitive point, the Fed obtained two statutory amendments to the CEA that addressed their special concerns. First, a broad exemptive power was added to the CEA, authorizing the CFTC to exempt virtually any agreement, contract, or transaction from

54. Id. at 42,984. This position was later adopted by the Second Circuit in a decision holding that option contracts on foreign currency (which contracts were sold to the general public) were within the jurisdiction of the CFTC, notwithstanding the Treasury Amendment. See CFTC v. American Bd. of Trade, 803 F.2d 1242, 1248 (2d Cir. 1986).
55. See Markham, supra note 53, at 10.
both the exchange trading requirements of the CEA and other provisions if it determined that "the exemption would be consistent with the public interest." 62 The express purpose of this provision was "to promote responsible economic or financial innovation and fair competition." 63 Although the exemption applied only to agreements, contracts, or transactions "entered into solely between appropriate persons," 64 it enabled the CFTC to exempt broadly swaps and hybrid instruments issued over the counter. Well aware that it had received a strong hint from Congress about how to use this new exemptive power (and given only a two-year reauthorization to keep it on a short leash), the CFTC granted the anticipated exemptions for swaps and hybrid instruments in early 1993. 65 As a result, swap dealers and others in the OTC derivatives markets seemed (for the time at least) to be beyond the reach of either the SEC or the CFTC (at least so long as they dealt only with "appropriate persons").

The second triumph for the Fed in the Futures Trading Practices Act of 1992 66 involved its authority to prescribe margin levels. Although the Fed had long argued that it possessed authority to prescribe margin requirements for futures on stock indexes, it had not attempted to exercise this authority, and the CFTC had claimed that the Fed's margin setting authority was limited to securities. 67 After the 1992 amendments, however, the CEA now requires any contract market in a stock index futures contract to file with the Federal Reserve Board any rule establishing or changing margin levels, and the Federal Reserve Board "may direct the contract market to alter or supplement [its] rules." 68

In overview, although the border disputes between the Fed and the CFTC were never frontal or dramatic, the last decade has shown the Federal Reserve Board to be a powerful player in regulatory turf wars, as well as an opponent of rent-seeking attempts by any other group to subject the Fed's "banking clients" to the jurisdiction of their own "friendly" regulator. As a result, the CFTC and the Chicago futures exchanges may have become almost as anxious about Fed oversight as they were resistant to any transfer of jurisdiction to the SEC.

The SEC/CFTC Rivalry

Although the Fed has been largely victorious in its turf skirmishes with the CFTC, the reverse can be said for the SEC; it has continually tried to

63. See 7 U.S.C. § 6(c)(1).
64. See id. § 6(c)(2)(B)(i). Thus, the CFTC preserved some of the ground it sought to stake out in its 1985 Statutory Interpretation. See supra note 55 and accompanying text.
67. See Kane, supra note 1, at 381.
gain authority from the CFTC, but has had only limited success, which has been confined largely to the context of stock index futures. In fairness, the responsibility for much of this conflict must be assigned to Congress. Congress has simply been obscure. In creating the CFTC in 1974, Congress seemed to preempt the field of commodity futures regulation by conferring exclusive jurisdiction on the CFTC. Although the creation of the CFTC effectively precluded the SEC from asserting jurisdiction over commodity options (as the SEC had previously sought to do), the CEA's legislative history stated that the 1974 amendments creating the CEA were not intended to supersede the jurisdiction of the SEC. Confusion was thus present from the outset as to the location of the dividing line between the CFTC's and the SEC's authority.

Conflict came a year later. In 1975, the Chicago Board of Trade (CBOT) applied to the CFTC for designation as a contract market to trade futures contracts on GNMA certificates. Although the CFTC granted the application, the SEC formally objected to the CFTC's action, asserting that GNMA certificates and Treasury bills were securities and thus should be subject exclusively to SEC jurisdiction.

Although the SEC lost this first skirmish, it tried three years later to win the war in a single preemptive strike. In 1978, the SEC asked Congress to give it jurisdiction over all derivative products relating to underlying instruments that were securities (whether futures or options in form). Its attempt was probably influenced by the fact that the CFTC had been criticized for several scandals and seemed vulnerable. The Treasury and the General Accounting Office also made proposals that would have reallocated much of the CFTC's jurisdiction. Congress, however, made only modest changes to the CEA, requiring the CFTC to consider the views of the Treasury and the Federal Reserve Board before allowing a contract market to trade a futures contract that involved a security issued or granted by the United States or one of its agencies.

The tide turned in the CFTC's favor the following year. In 1978, the SEC granted the Chicago Board Options Exchange's (CBOE) application to trade options on GNMA certificates, thus authorizing the CBOE to trade a derivative instrument largely paralleling the futures contract on

71. See Markham, supra note 53, at 11.
GNMA certificates already traded on the CBOT. The CBOT sued and won an injunction in the Seventh Circuit that enjoined the CBOE from trading the options. The Seventh Circuit also found that the SEC lacked the authority to authorize the trading of GNMA options because they fell within the exclusive jurisdiction of the CFTC.

This decision precipitated a crisis, that ultimately resulted in an agreement between the chairs of the SEC and the CFTC (known as the "Shad/Johnson Accord") that allocated jurisdiction between the two agencies. Questionable as the authority of commission chairpersons to allocate jurisdiction may be, this division was more or less ratified by Congress in subsequent legislation with only minor changes. Under this allocation, the CFTC received exclusive jurisdiction over futures contracts, option contracts on commodities, and option contracts on currencies (except those traded on a national securities exchange), but was precluded from allowing options or futures contracts on equity securities. The CFTC could, however, authorize futures on securities indexes and options on futures indexes. In effect, each agency obtained jurisdiction over a close substitute relating to security indexes: the SEC could authorize options on stock indexes and the CFTC could permit futures on securities indexes (and also options on futures indexes).

Detente lasted only until the 1987 stock market crash. In its wake, the SEC informed Congress that the existence of a futures market in stock indexes had disrupted the stock exchanges and threatened their future stability. The New York Stock Exchange made a similar claim that program trading through the medium of futures on indexes disrupted the securities markets and exacerbated stock volatility. Again, the SEC requested that Congress transfer jurisdiction over futures on stock indexes from the CFTC to the SEC. Again, it lost this fight, although it came close and at one point the Wall Street Journal predicted that it was about to win its battle for regulatory turf.

Meanwhile, both sides contested the murky territory between options on indexes and futures on indexes. In 1988, the SEC authorized the CBOE and certain stock exchanges to trade index participation contracts, which are contracts of indefinite direction whose value depends on an underlying

76. Board of Trade v. SEC, 677 F.2d 1137 (7th Cir.), vacated as moot, 459 U.S. 1026 (1982).
77. For an account of this era by a participant, see Phillip M. Johnson, Reflections on the CFTC/SEC Jurisdictional Dispute, in Regulating International Financial Markets: Issues and Policies (Franklin Edwards & Hugh Patrick eds., 1992).
78. 7 U.S.C. § 2.
81. See Keith Salwen, SEC Seems Likely to Win Turf War with the CFTC, WALL ST. J., Feb. 16, 1990, at Cl.
basket of securities. In effect, the holder of an index participation unit is in the same position as a holder of shares in a closed-end mutual fund that held a value-weighted portfolio of the securities in the index.

Predictably, the futures exchanges (both the CBOT and the CME) sued the SEC—and again won.\(^82\) Ruling again in favor of the home team, the Seventh Circuit found that index participation contracts were within the exclusive jurisdiction of the CFTC.\(^83\) In addition, in a companion action, the Seventh Circuit also overturned an SEC no-action position that allowed firms selling options on Treasury bills, bonds, and notes to do so without registering as a national securities exchange.\(^84\) Although this ruling was entirely on procedural grounds, it clearly threatened the OTC market in hybrid instruments.

Each side, however, imposed costs on the other’s clientele. Although the CFTC was able to bar index participations, the SEC had in turn been able to chill (albeit more quietly) the growth of some new financial products that were styled as futures. Probably the best example of the SEC’s inhibiting the appearance of new financial products involved the case of non-diversified stock futures contracts. Under the 1982 SEC/CFTC accord legislation, the CFTC was restricted in the stock indexes on which it could permit futures contracts to be traded. The CEA requires that “[s]uch group or index of securities shall be . . . a widely published measure of, and shall reflect, the market for all publicly traded equity or debt securities or a substantial segment thereof, or shall be comparable to such measure.”\(^85\) Known as the Substantial Segment Criterion, this provision had its origins in the SEC’s understandable concern that some sub-indexes could be created that amounted to only a thinly-disguised “surrogate” for trading in individual stocks. Thus, the use of small sub-indexes might permit de facto trading on the futures exchanges in individual stocks in a manner that could outflank the federal securities laws’ prohibition on insider trading. Relying on this concern, the SEC overreacted and resisted any single industry futures contracts as a surrogate for trading in individual stocks.\(^86\) Moreover, the SEC argued broadly that Congress had intended “to constrain the ability of futures exchanges to produce substitutes for stock exchange products.”\(^87\) Such a claim attributes a transparently anti-competitive intent to Congress: Why should the rival exchanges not trade functional substitutes and let investors decide which to purchase?

83. Id. at 548.
84. Board of Trade v. SEC, 883 F.2d 525 (7th Cir. 1989).
85. See 7 U.S.C. § 2a(ii)(III). For a discussion of the debate over this provision, see Kane, supra note 1, at 378.
86. See Kane, supra note 1, at 379.
87. Id.
Predictably, the CFTC resisted this SEC attempt to prohibit futures on single industry sub-index options. In early 1984, the CFTC approved a CME sub-index futures contract, and the stage was set for possible litigation. Ultimately, however, the two agencies settled. The CFTC and the SEC published a joint interpretive release, setting forth four basic numerical criteria that stock index futures must meet before they can be designated for trading:

1. *Minimum number of securities* (at least 25 domestic issuers);
2. *Index capitalization* (the aggregate capitalization of the component securities must be at least $75 billion);
3. *Percentage Weight Afforded Larger Stocks* (no single security could represent more than 25% of the index's aggregate capitalization); and
4. *Percentage Weight Permitted Three Largest Stocks* (no three stocks could account for more than 45% of the index).

In addition, special and even more restrictive rules were specified for non-capitalization weighted indexes. Interestingly, the CBOT decided that the CFTC had abandoned the interests of the futures exchanges in this compromise, and it sued unsuccessfully to enjoin this interagency compromise.

In overview, much in this episode seems instructive about the conceptual deficiencies in the simple model of regulatory competition. First, the outcome was not what the model predicts: innovation was inhibited, not enhanced, by the agency rivalry. Although the SEC's criteria for permissible non-diversified stock indexes seemed overly prophylactic and anti-competitive, the SEC still won. Even if it may be appropriate to place some limit on the percentage that any single stock can bear to the index's aggregate capitalization, the need for other limitations—such as the forty-

88. *Id.*
89. *Id.*
90. *Id.* This settlement may have reflected the SEC's strong legal position, because the 1983 CEA amendments gave it a right to block those stock index futures contracts initiated after December 9, 1982 that it determined failed to satisfy the minimum requirements set forth in the CEA (including the "substantial segment" criterion). See 7 U.S.C. § 2a(iv)(II). While aggrieved persons could sue with respect to the SEC's determination, they would face the usual uphill battle of someone challenging an agency determination.
92. *Id.*
93. The district court did not address the merits of the CBOT's contentions, but found that the Board was required to exhaust its administrative remedies before it could sue. See Board of Trade v. CFTC, Fed. Sec. L. Rep. (CCH) ¶ 91,437 (N.D. Ill. Mar. 30, 1984). Both the SEC and the CFTC described the joint release as only an interpretive rule and thus exempt from the notice and comment provisions of the Administrative Procedure Act.
five percent limitation on the three largest stocks—seems more questionable. Such limitations may in effect bar domestic financial firms from creating (and investors from buying) securities indexes with regard to those industries that are highly concentrated (as many high-tech and developing industries are likely to be early in their history). For example, in its unsuccessful litigation with the SEC and the CFTC over this issue, the CBOT asserted that it then had pending applications for five stock index futures contracts that it predicted could not pass the SEC’s and the CFTC’s new joint criteria. In short, the SEC’s fear that stock index products traded through the medium of futures contracts could prove a vehicle for insider trading imposed a direct cost on investors—denial of easy access to a range of financial products for which there presumably would be a market. Possibly, too, the SEC’s expansive interpretation of the “substantial segment” criterion was motivated, at least in part, by its explicit distaste for new futures products that paralleled exchange-traded securities instruments.

If one accepts this assertion that the SEC overreacted to the threat that non-diversified stock indexes could be used as a vehicle for insider trading, three further conclusions tend to follow. First, whatever their benefits, regulatory battles are likely to impose a significant cost on the capital markets by impeding new product development. Second, when regulatory battles ensue, the new product does not disappear, but rather moves offshore, and some volume of trading thereby migrates away from U.S. markets. Third, when agencies battle with each other, they create a legal “no man’s zone” that entrepreneurs on both sides of the regulatory fence fear to enter. As a result, regulatory competition at home may hasten the migration abroad of new products and trading.

The problem, then, with the simple regulatory competition model is that it focuses only on the benefits that rival regulators can provide to attract clients, but not on the costs that they can impose to deter exit. This model of regulatory competition assumes that entrepreneurs pick their regulator and, if it later overregulates inefficiently, they switch to a less demanding regulator. Indeed, both the proponents of the “race to the bottom” scenario and those of the naive version of the regulatory competition model share this assumption (although they agree on little else). Essentially, they assume passivity on the part of regulators, and this is an unjustified assumption. The history of the SEC and the CFTC turf battles throughout the 1980s demonstrate that when two agencies share overlapping jurisdiction over functional substitutes, each agency is likely to possess some blocking power or veto authority over transactions that market participants regulated by the other wish to engage in. The result can be a dead-weight social loss, as presumptively efficient and value maximizing transactions are barred by both agencies. Indeed, the SEC/CFTC jurisdictional wars provide a paradigm of this process at work. On one hand, the CFTC

94. See id. at 98,189.
blocked the index participations that both the CBOE and the Philadelphia Stock Exchange sought to trade, and, on the other, the SEC severely restricted non-diversified stock index futures. Neither side stands out as the villain or the hero in this story; rather, each side generated a regulatory penumbra around its core statutory jurisdiction within which it was able to bar firms regulated by the other from entering.

To be sure, the new products did not disappear. The Toronto Stock Exchange began trading an index participation product, apparently with some success. Foreign futures exchanges have begun to trade futures on individual stocks, thus underscoring the cost of the SEC's "substantial segment" criterion. Just since 1986, the share of the world's futures trading conducted on American exchanges fell from eighty percent to under fifty percent.

Nor are the foregoing instances unique. Other products have also sailed into the legal Bermuda Triangle between the CFTC and the SEC. In 1993, the CFTC announced that it might challenge Salomon's "Elks" hybrid as in effect a futures contract, and the Options Clearing Corporation has raised problems about the legal status of the Amex's "Bounds." Both sides, then, by creating legal uncertainties, are able to impose a regulatory tax on firms regulated by the other.

Regulators Abhor a Vacuum: Convergence on the OTC Derivative Market

The over-the-counter market in swaps and derivatives long stood as a counter-example to the hypothesis that regulatory competition produces overlapping regulatory regimes and hence overregulation. Despite statutory language that could be stretched to reach these instruments, neither the SEC nor the CFTC attempted to regulate over-the-counter derivatives. When in 1993, the CFTC granted a broad exemption for swaps and hybrids, the over-the-counter market in derivatives seemed to have escaped

95. See Johnson, supra note 77, at 145. The Philadelphia Stock Exchange has also continued to try to redesign its index participation contract to escape legal problems—thus suggesting that the product had a marketing appeal. See Hal Lux, Index Participations May Rise from the New Product Graveyard, Phlx Considers Reviving a Controversial Product, INVESTMENT DEALERS' Dig., Jan. 11, 1993, at 5.
96. For example, the Sydney Futures Exchange now trades futures on individual stocks, and others are likely to follow. See Michael Peltz, Days of Futures Past?, INSTITUTIONAL INVESTOR, June 1994, at 183, 184.
97. Id. at 183.
98. See Tom Pratt, CFTC May Challenge 'Elks' Hybrid Developed by Solly, Product May Be Too Similar to a Futures Contract, INVESTMENT DEALERS' Dig., Sept. 13, 1993, at 22.
regulatory oversight. This victory for the OTC dealers proved, however, to be short-lived. In 1994, Gibson Greetings, Inc. sued Bankers Trust New York Corp. (Bankers Trust) over certain swaps and derivative transactions between them, and the evidence strongly suggested that Gibson Greetings had been overreached.\footnote{Bankers Trust ultimately agreed to pay a $10 million civil penalty to the United States Treasury and settled the Gibson Greetings action on highly favorable terms to the plaintiff. \textit{See John C. Coffee, Bankers Trust Settlement: Whither the Swaps Market, N.Y. L.J., Jan. 26, 1995, at 5; Stephen F. Selig, Gibson Greetings Versus Bankers Trust: The Case Has Ended But the Issues Linger On, INSIGHT's, Jan. 1995, at 21.}} In rapid succession, the Federal Reserve Board, the SEC, and the CFTC entered the fray and each negotiated a consent decree or similar agreement with Bankers Trust and its broker-dealer subsidiary, BT Securities Corp. (BT).\footnote{See \textit{In re BT Sec. Corp.}, Securities Act Release No. 7124, 1994 SEC LEXIS 4041; CFTC LEXIS 340 (Dec. 22, 1994).} The SEC and the CFTC cooperated closely in reaching their respective settlements with Bankers Trust, and their two opinions are virtually word-for-word identical. Despite this unusual level of cooperation, the critical fact for the future is that both agencies effectively asserted jurisdiction over the same legal terrain.

Although no binding legal precedent was established by these settlements, the practical consequence is that not only will the SEC and the CFTC claim jurisdiction in the future, but private plaintiffs can be expected to follow in these footsteps, asserting claims, for example, under Rule 10b-5. In addition, the Federal Reserve Board required Bankers Trust to develop suitability and transparency standards and procedures, to establish new marketing and sales practices policies that were "consistent with safe and sound banking practices," to augment training and internal audit procedures, and most importantly, to suspend (at least temporarily) the sale of certain highly leveraged derivative products.\footnote{See Written Agreement By and Among Bankers Trust New York Corp., Bankers Trust Co., BT Securities Corp., and the Federal Reserve Bank of New York, Dock. No. 94-082, Board of Governors of the Federal Reserve System (Dec. 4, 1994); \textit{see also} 63 Banking Rep. (BNA), No. 22, at 893 (Dec. 12, 1994) (available on LEXIS, News library, Curnus file).} The Federal Reserve's settlement with Bankers Trust was communicated to the banking industry as a broad statement of policy by the Fed as to procedures and policies that it expected other banks to observe and implement as well.\footnote{An accompanying Federal Reserve Press Release indicated that the Federal Reserve Board expected other banks active in the swaps market to develop similar practices and policies.}

In short, the contest for regulatory hegemony over the OTC derivatives market now has three active participants, none of whose edicts or standards can be safely ignored by those regulated.

Of the three agencies, the CFTC asserted the narrowest theory of jurisdiction: because of BT's role as trusted and confidential advisor to Gibson
Greetings, BT became, in its view, a “commodity trading advisor,” and, thus fraudulent misrepresentations made by it violated section 4(o)(1)(A) of the CEA. Read narrowly, such a fact-based resolution has less impact on other OTC dealers (except to the extent that they too could be subject to CFTC discipline for fraudulent activities). To become a “commodity trading adviser,” however, BT had to be selling Gibson Greetings something, at some point, that constituted either a commodities option or a futures contract. Although the CFTC’s opinion was diplomatically vague on this score, its conclusion that BT was a “commodities trading adviser” implied that swaps were sometimes either futures contracts or commodities options. Even if thinly veiled, this analysis meant the CFTC was contending that it had jurisdiction (although it was willing to exempt such instruments from most provisions of the CEA).

In contrast, the SEC’s opinion left no doubt that it claimed jurisdiction. Its opinion contended that at least one interest rate swap sold by BT was, in economic substance, an option and thus a security. Hence, fraud in connection with their purchase or sale violated Rule 10b-5 and other antifraud provisions of the federal securities laws. From the perspective of OTC dealers, the problems in this approach were enormous. First, private plaintiffs also have the ability to utilize Rule 10b-5 and hence, by deeming swaps sometimes to constitute securities under vague criteria, the SEC was subjecting OTC dealers to potential liability to private litigants. Second, if swaps can sometimes be securities, then the OTC dealers who sell them must register as broker-dealers with the SEC. To avoid market disruption, the SEC responded to this latter problem by granting a retroactive, but temporary, exemption to OTC derivative dealers from broker-dealer registration with regard to transactions in similar debt securities. This exemption expires, however, on September 30, 1995, and thereafter OTC dealers may well be forced to register as broker-dealers (and comply with the SEC’s net capital rules as a consequence).

Doctrinally, some have argued that the SEC had little choice in adopting its broader approach because the federal securities laws are written so as to require an initial finding that an instrument constitutes a security before the SEC gains even antifraud jurisdiction. This justification is overbroad.

105. Section 1(a)(5) of the CEA basically defines a “commodity trading advisor” as a person who for compensation or profit (1) advises others as to the value or advisability of trading in futures contracts or commodity options, or (2) promulgates analyses or reports concerning such activities. 7 U.S.C. § 1(a)(5)(A).
106. Id. § 6(o)(1)(A).
110. 17 C.F.R. § 240.15c3-1 (1994).
as applied to the facts of the Bankers Trust case, however, because there were alternative grounds on which BT Securities, a registered broker-dealer, could be subjected to sanctions.\textsuperscript{111}

Even if there had not been satisfactory alternative grounds, the SEC's position that interest rate swaps can sometimes constitute securities still seems questionable. In its Release,\textsuperscript{112} the SEC argued that one particular derivative transaction between Bankers Trust and Gibson Greetings (known as the "Treasury-Linked Swap") was really a "cash settled put option that was written by Gibson."\textsuperscript{113} Under the terms of this transaction, however, both Bankers Trust and Gibson Greetings exchanged interest rate payments on a $30 million nominal amount for eight months. Then, on maturity, Gibson Greetings was to pay Bankers Trust $30 million, and Bankers Trust would pay the lesser of $30.6 million or an amount determined under a formula based on the spread between the price of the thirty-year Treasury security and the arithmetic mean of the bid and offered yields on the most recent two-year Treasury notes.

There are at least three possible flaws in the SEC's analysis. First, the entire transaction was bilateral in character, with each side committed on an executory basis to making payments to the other on the settlement date. This element of bilateral obligation has long been a factor that both the SEC and the courts have stressed in distinguishing a futures contract from an option.\textsuperscript{114} Second, either Bankers Trust or Gibson Greetings could have profited on the settlement date, whereas in a true option contract, only the option buyer can receive a payment on the expiration date (whereas the option writer's profit is entirely front-loaded and reflected in the premium it receives at the outset of the contract). Finally, even if there are elements of an option in the contract, the case law treats ambiguous instruments that are both a futures contract and a security as subject to the CFTC's jurisdiction.\textsuperscript{115}

On one level, the Bankers Trust episode simply may prove again the old adage that hard cases make bad law. Strong evidence of fraud understandably propelled both the SEC and the CFTC into aggressive action. Prior to this crisis, neither the SEC nor the CFTC had ever formally expressed the view that swaps constituted securities or futures contracts.\textsuperscript{116} Now,

\textsuperscript{111} For example, the SEC's opinion expressed the view that in supplying misleading financial information to Gibson Greetings, which it knew Gibson Greetings would use in preparing its financial statements, BT violated §13 of the Securities Exchange Act of 1934. \textit{See In re BT Sec. Corp.}, Securities Act Release No. 7124, 1994 SEC LEXIS 4041 (Dec. 22, 1994).

\textsuperscript{112} \textit{See id.}

\textsuperscript{113} \textit{Id.} at *6 n.6.

\textsuperscript{114} \textit{See Chicago Mercantile Exch. v. SEC}, 883 F.2d 537, 541, 546 (7th Cir. 1989).

\textsuperscript{115} \textit{Id.} at 544 ("[I]f an instrument is both a security and a futures contract, then the CFTC's jurisdiction is exclusive").

\textsuperscript{116} \textit{See Selig, supra note 101.}
both have claimed jurisdiction over at least some interest rate swaps, and
this faces the industry with the worst of both worlds: two regulators ad-
vancing overlapping theories of exclusive jurisdiction. In this light, the
Bankers Trust episode illustrates that enforcement decisions dominate pol-
icy planning, even after decades of restraint. The deeper lesson from this
story, however, begins from Yogi Berra's observation that it is déjà vu all
over again. Despite their honest attempts to cooperate in the Bankers Trust
episode, the SEC and the CFTC again asserted seemingly overlapping and
inconsistent theories of jurisdictions. This was neither the first time this
occurred, nor is it likely to be the last. In a competitive environment,
agencies on both sides of a fuzzy line will predictably overstep. The ob-
served result is that regulatory competition in practice does not permit
the regulated population to choose its preferred regulator, but rather
tends to subject them to dual (and thus excessive) regulatory regimes with
little ability to choose between them.

As a result, the OTC derivatives industry today faces uncertainty. Con-
ceivably, dealers could omit the "embedded option" element from future
swaps that they offer (and thereby escape the SEC), or they could structure
the transaction as an explicit put option on Treasury securities (and thus
arguably avoid the CFTC). But presumably the mixture of elements that
they had chosen (i.e., bilateral interest payments and a final bilateral no-
tional balloon payment that resembles an option) had some efficiency ad-
vantages that attracted customers. Hence, if these hybrid instruments are
chilled by the specter of dual jurisdiction, there is presumably some effi-
ciency loss, and the capital market no longer "spans" all combinations of
risk and return. The bottom line then is that regulatory competition re-
stricts the products that the market can offer.

A Preliminary Evaluation

Because the problem of interagency conflict is a recurrent one, it is
important to define when agency competition can impose costs on regu-
lated firms. In abstract theory, regulatory competition works when the
regulated firm has mobility but the competing agencies are securely cab-
inied by clear jurisdictional lines that they cannot exceed. The Bankers
Trust episode suggests that in reality, jurisdictional lines are rarely that
fixed but rather become fluid in a crisis. In this light, the defining char-
acteristic of the inefficient regulatory competition is the existence of over-
lapping jurisdiction. This overlap can be the product of statutory ambiguity
or other legal uncertainty, and it need not extend to the particular product
or transaction at issue. It is sufficient that a firm is subject in any important
aspect to an agency's discretionary jurisdiction. If so, then even if the firm
has a right to move some of its activities from one agency to another, the
firm remains potentially subject to retaliation.

If overlapping jurisdiction is the critical precondition, it follows that
regulatory competition is more likely to produce retaliatory (and ineffi-
cient) battles at the agency level than in the context of interstate competition. At the state level, the negative impact of the dormant Commerce Clause provides some protection for firms moving their place of incorporation from one jurisdiction to another. In principle, the internal business affairs of a corporation can only be regulated by the jurisdiction of incorporation. This abstract principle, however, is, itself, subject to significant inroads, as some states have passed “pseudo-foreign incorporation” statutes applicable to those corporations having substantial contacts with their jurisdiction, and much substantive regulation of internal corporate governance can be achieved without purporting to do so. Still, the problem of overlapping jurisdiction arises more commonly at the federal level. Compounding it is not only the tendency of Congress to write both obscurely and expansively in defining the authority and jurisdiction of agencies, but also the seriatim fashion in which statutes are enacted. Lines are seldom drawn between two agencies; rather, each is successively empowered to assert a broad jurisdictional reach.

The inevitable costs of regulatory competition might be justifiable if the benefits of that competition clearly exceeded these costs. The benefits of regulatory competition, however, depend on competition being the norm, not the exception. Here, another major problem surfaces: agencies can collude as easily as can firms—and, unlike firms, can do so lawfully. When private firms collude, such behavior is a per se violation of the antitrust laws. By contrast, when agencies reach agreements that in effect divide the regulatory turf between them, this behavior is usually praised as statesmanlike, and both courts and Congress alike tend to defer to compromises so struck. The SEC and the CFTC rivalry again illustrates this tendency. Congress essentially ratified the Shad/Johnson accords, and courts deferred to the SEC and the CFTC’s agreement on non-diversified stock indexes. Again, in the Bankers Trust episode, both agencies essentially

117. U.S. Const. art. I, § 8, cl. 3.
119. See, e.g., N.Y. Bus. Corp. Law § 1315 (McKinney 1986); Cal. Corp. Code § 2115 (West 1988). Although the constitutional validity of these statutes can be questioned, federal courts continue to uphold them. See, e.g., Sadler v. NCR Corp., 928 F.2d 48 (2d Cir. 1991) (requiring Maryland corporation to provide shareholder list complying with New York law’s requirements); Wilson v. Louisiana-Pac. Resources, Inc., 138 Cal. App. 3d 216 (Cal. Ct. App. 1983); see also Mark E. Kruse, Comment, California’s Attempt to Regulate Foreign Corporations: Will It Survive the Commerce Clause?, 16 San Diego L. Rev. 943 (1979).
120. State “blue sky” statutes provide a good illustration of how “overlapping” jurisdiction can still result at the state level if securities will be offered in multiple states. See, e.g., People v. Western Air Lines, Inc., 258 Cal. App. 2d 213 (Cal. Ct. App. 1968) (Delaware corporation not permitted to issue securities in California unless certificate of incorporation contained cumulative voting provision).
121. See supra notes 93 & 94 and accompanying text.
agreed to share jurisdiction. Yet, at least within the four corners of the regulatory competition model, such behavior reduces both the possibility that a regulated firm can “escape” from one agency to another, and the value of such exit because there are less likely to be significant differences between “colluding” regulatory regimes.

Although the simple regulatory model ignores the possibility of regulatory cooperation, even the most casual observation reveals that cooperation is the norm, not the exception, in administrative behavior. In reality, the actual environment in which administrative agencies function resembles not the atomistic market of perfect competition but a heavily concentrated industry in which there are usually no more than two dominant firms. In such an environment, absent strict enforcement, oligopoly is highly likely in the private sector, and even more predictable in the public sector, where there is no legal barrier to such “cooperation.”

The incentives for administrative collusion are probably greater in the case of federal agencies than in the case of competition among states. As regards state competition, any migration of firms and entrepreneurs to the more hospitable jurisdiction will be accompanied by a transfer of tax revenues (and possibly other benefits) that rewards one jurisdiction and disciplines the other. But, because there is no automatic or corresponding reallocation of tax revenues or budgets in the case of federal agencies, the benefits to the winning regulator tend to be intangible. The prestige of the “winning” regulatory agency may be marginally enhanced, but success in this competition also implies increased workload and risks of controversy. Overt competition may also embarrass the Administration to which the politically responsive heads of both agencies report.

Put differently, the key advantage of cooperation (or “collusion”) to bureaucrats is the same as it is to managers of firms in oligopolistic or monopolistic markets: it permits them to enjoy the advantages of the quiet life, safe from the risk that their constituency of regulated firms might suddenly flee. Just as private firms would like to have captive customers, so may agencies prefer a safe clientele to an active competition in which they could lose.

These observations do not deny that competition between regulatory agencies can break out (as clearly happened for a time between the CFTC and the SEC during the 1980s), but they lead to the prediction that internal forces within the competing agencies are likely to push each toward an accommodation. To the extent that one accepts this premise that agency collusion is more likely than agency competition, the benefits of a regulatory structure in which two (or more) rival agencies share partial jurisdiction over an integrated market are radically reduced in importance,

122. This may provide careerist benefits to that agency’s staff and may increase the rate of political contributions to the members of the congressional committees having oversight over it.
because efficient competition between the two agencies is likely to be only an occasional phenomenon.

In summary, one can draw three primary conclusions from the analysis in this section: (i) to the extent that agencies do compete, they may do so in inefficient and retaliatory ways that could visit externalities (particularly including the cost of regulatory uncertainty) on regulated firms, which costs may outweigh the benefits from their competition; (ii) the benefits of regulatory competition may be obtainable even with regulatory consolidation at the federal level because the impact of the globalization of securities and commodities markets is to make off-shore migration likely in the face of inefficient regulation; and (iii) the assumption that agencies will compete is invalid because there are also incentives for collusion. These observations are not intended as iron laws, but only as generalizations that follow from a reasonably careful examination of the troubled relationship between the CFTC and the SEC over the last decade.

THE CASE FOR REGULATORY CONSOLIDATION

That the arguments for regulatory competition may be flawed does not mean that there are necessarily fewer problems with the case for regulatory consolidation. This section will consider the arguments for consolidation, which essentially fall under three main headings: (i) Public Choice arguments (which essentially stress that consolidation may reduce the prospect of agency capture), (ii) Market Failure arguments (including the standard "race to the bottom" scenario and more plausible externality arguments); and (iii) Economy of Scope and Scale arguments (which suggest that a larger agency can take different and more integrated measures than a smaller agency). As will be seen, there are problems with each of these arguments, although none is implausible.

THE PUBLIC CHOICE JUSTIFICATION

Modern public choice theory tells a standard story about why regulation fails:

The Inevitability of Rent-Seeking Behavior

Gain-seeking individuals who are affected by governmental action will predictably seek to influence governmental processes to obtain outcomes favorable to themselves (i.e., "rent-seeking"). In particular, small cohesive groups of individuals who are (or would be) the most affected by government are likely to expend greater resources and have disproporti-

tionate impact on governmental policy. Their success in pursuing rent-seeking policies to obtain regulatory protection will often be at the expense of larger, less organized groups (such as, ultimately, the general public). Because the general public, with each of its members suffering only minor losses as a result of rent-seeking behavior by special interest groups, finds the costs of collective action to be too high to organize in opposition to these interests, the regulatory process will predictably tend to produce rent-seeking measures under which special interests prevail at the expense of the broader society and economic efficiency.

**Agency “Capture” and Organizational Size**

Rent-seeking groups may sometimes succeed in “capturing” an administrative agency, staffing it with their own representatives and using it to generate regulatory protection for themselves and to erect anti-competitive barriers to exclude potential entrants into their markets. The likelihood of such capture (and the permanence of the conquest) may depend on a variety of factors, but the greater the size, visibility, and organizational interests affected by the agency, the more difficult and costly such capture may become. A contrast can arguably be drawn here between the SEC and the CFTC: the former was long thought to have successfully resisted “capture,” while the newer, smaller CFTC was viewed by many as a more parochial agency, with jurisdiction over a smaller constituency of interest groups, and thus more vulnerable to capture. State insurance commissions probably afford the clearest example that small agencies with limited jurisdiction and influence are the most vulnerable to capture.

The premise that increased organizational size and jurisdiction protects an agency at the margin from capture, if accepted, may provide an additional rationale for regulatory consolidation. That is, if merged, the SEC and the CFTC may be better able to resist rent-seeking behavior than either would be separately. But to make this assertion is not to accept it uncritically. For example, the capture of just a portion of an agency may be possible and, even more, desirable in some circumstances. The CME’s proposal raises exactly this possibility because its proposed Division of Risk-Shifting Markets would be a largely autonomous continuation of the existing CFTC (with enhanced jurisdiction over options and swaps). Although new policy initiatives would be subject to the approval of the nine commissioner board of the FFRS, its staff would presumably enter from the futures industry and, in time, exit to it. In such an environment, careerist motives might still loom large, and staff might seek to curry favor

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124. See Krueger, supra note 123, at 302.
125. Id.
126. See id.
127. See Wiley, supra note 35.
128. See supra note 25.
with the industry. If the industry could "capture" the commissioner heading this division, its control over the agency would be far from complete, but its day-to-day influence would remain very strong.

REGULATORY MARKET FAILURE JUSTIFICATIONS FOR REGULATORY CONSOLIDATION

Because regulatory competition as a strategy for pursuing economic efficiency essentially depends on the concept of a market for regulation, evidence of imperfections in this market may supply at least some justification for preferring consolidation to competition. Two types of regulatory market failure arguments are commonly made: (i) "race to the bottom" claims that competition will ultimately produce sub-optimal regulation at both agencies, and (ii) externality arguments under which one agency is not required to internalize the costs it imposes on others. Each merits a separate analysis and may justify quite distinct limits on regulatory competition.

The "Race to the Bottom" Scenario

The structure of this argument assumes that one regulator (whether a federal agency, a state, or a sovereign nation) has established a level of regulation it considers optimal, but the subjects of this regulatory regime are mobile and can relocate elsewhere at some non-prohibitive cost. Another regulatory regime establishes a lower, less stringent level of regulation in order to attract this mobile population (and, with it, the tax revenues, jobs, wealth, or other associated economic benefits that come to a regime that can attract migrants). To recover and compete, the first regulator lowers its standards to a level at or below those of the second regulator, and soon the race is on. If it is assumed that the two regulators have less than perfect information about each other's intentions and capabilities, this process of adjustment and reactive readjustment continues until a new equilibrium is obtained at which neither state has any incentive to lower its standards further. If they have perfect information, the adjustment may be instantaneous. Either way, the end result is that both regulatory regimes end up with systems of sub-optimal regulation and will not experience any significant inflow or outflow of regulated firms. Both are made worse off, and the outcome can be described as Pareto-inferior.

129. See Butler & Macey, supra note 6.
So stated, the "race to the bottom" scenario is a form of the classic Prisoner's Dilemma. In the standard example, two suspects are separately interrogated by a prosecutor who is seeking to pressure them into confession. If neither confesses, the prosecutor will only obtain misdemeanor convictions, and a one-year sentence against each. If only one confesses, the prosecutor will offer that one a plea bargain with only a six-month sentence, but the other non-confessing defendant will then be convicted and receive a ten-year sentence. If both confess, they will each be convicted of a felony and will receive five years each. On these facts, and assuming the two defendants cannot communicate and reach a binding agreement not to confess, it is rational to confess, but collectively this outcome is Pareto-inferior.

The key to the Prisoner's Dilemma is the inability to cooperate. In the standard interstate version of the "race to the bottom," the corresponding problem is that the two rival states do not trust each other to reach an agreement on some optimal level of regulation that each will enforce. Each fears the other will welch (thus leaving the non-welcher in the same position as the prisoner who does not confess when the other prisoner does). Thus, proponents of the "race to the bottom" scenario view federal regulation as the answer to this problem of non-cooperation, because by opting for federal regulation, the two states are actually invoking an enforceable mechanism by which to agree on a common level of regulation. Similarly, to the extent that the competition between federal agencies amounts to a race to the bottom, the parallel answer can be consolidation (either through merger or through the creation of some appellate regulator with authority over both).

But there are serious problems with the "race to the bottom" scenario. Above all, it assumes what is to be proven: that competition is socially undesirable and will result in sub-optimal regulation. Perhaps, the two regulators honestly disagree about the level of regulation that is optimal; or perhaps, each is right with regard to the special context it faces (for example, the case for margin restrictions could be more persuasive for stocks than for futures).

A possible response of those favoring the "race to the bottom" scenario is that the migration of firms from one jurisdiction to another is itself socially undesirable because it will leave the jurisdiction (or agency or nation) suffering the outflow with less revenues, fees, or clout to support its existing activities at the same level. There are two simple responses to this claim. First, economists often distinguish between technological externalities and pecuniary (or pseudo) externalities. An increase in demand

or costs may affect prices and the welfare of buyers and sellers, but there is no misallocation of resources. When a rival jurisdiction effectively reduces the costs of production to a producer, this may spur migration, but it does not produce any misallocation of resources in any economically meaningful sense. 133 Second, even if a migration of firms does impose some social costs or injury on persons in the jurisdiction experiencing the outflow, the claim that such a migration between federal agencies produces any social injury seems far weaker. In such a case, there typically will be no physical movement or decrease in local tax revenues. Thus, the real question becomes whether there are true or "technological" externalities that can be attributed to regulatory competition between federal agencies.

**Externality Arguments**

The paradigm of the true or "technological" externality caused by regulatory competition is that of the upwind state whose pollution blows across the state line and lands primarily on its downwind neighbor. In such a setting, citizens of the upwind jurisdiction have little incentive to upgrade their regulatory standards because they would bear most of the costs and yet receive few of the benefits from any increase in regulatory standards. Hence, it is predictable that the upwind jurisdiction will "underregulate," and this scenario does not significantly depend on a desire of either jurisdiction to compete for migratory firms.

But can a similar scenario in which one rival imposes real costs on another be identified with regard to regulatory competition among federal agencies? Clearly, the case is harder to make. The SEC, however, has already (at least implicitly) made such an argument. Following the 1987 stock market crash, it argued that the impact of stock index futures trading was the destabilization of the equities markets on the stock exchanges. 134 Although the accuracy of this charge is highly debatable, this is at least a form of true or "technological" externality: costs are imposed on another and not internalized by the producer.

But what benefit does the CFTC gain from permitting such a claimed externality to be visited on the stock exchanges? One can argue that the CFTC's staff gains some careerist advantages to the extent that the enhanced stature of their agency will translate into higher remuneration for them when they return to private practice. Or, one can fall back on a "capture" argument and hypothesize that firms that profit from trading in stock index futures "captured" the CFTC and caused it to act in their interests (rather than in the public interest). Still, the incentives to the agency here are clearly weaker than in the context of interstate regulatory competition where tax revenues to the state are directly and significantly affected.

133. See Revesz, *supra* note 130, at 1222-23 & n.34.
134. See *supra* note 79 and accompanying text.
Other examples of "true" externalities are more speculative. Take, for example, the specter that clearly frightens U.S. stock exchanges, namely that foreign stock exchanges will begin (as at least one has) to trade futures on individual listed U.S. corporations. Is there a "true" externality here if investors have the choice between buying stock in General Motors on the NYSE or a futures contract in Sydney based on General Motor's stock price? Or are the claimed externalities only rationalizations for a desired immunity from competition? Although derivatives are viewed by many as a source of increased systemic risk, it is hard to make this case for futures on individual stocks (as opposed to stock indexes). Because futures transactions are guaranteed by the exchanges themselves there is not the same counterparty risk that exists in the case of swap transactions and other over-the-counter derivatives.

One possible externality may involve the reputational capital of the competing agencies and markets. Because the line between securities and futures is unclear in the public's mind and because an exchange might someday trade instruments that were subject to the jurisdiction of different agencies, a scandal involving an "underregulated" instrument or transaction might result in a reputational cloud over an agency or market that had no actual responsibility for the scandal. Still, even if such an externality is possible in theory, it does not yet seem very plausible.

A more subtle externality problem can be posited if the NYSE is viewed as a bonding mechanism that lends its reputational capital to firms that list on it (and in turn enforces some minimal standards of good corporate governance that are not legally mandatory). The NYSE is essentially compensated for the reputational capital it lends to listed firms through the volume of transactions in those stocks conducted on the NYSE. If a rival exchange trades NYSE-listed stocks, it is arguably free-riding on the NYSE's carefully nurtured reputation. Thus, there is a positive externality here, and it implies that the NYSE will underinvest in maintaining its own reputational capital. The problem with this argument, however, is that it is anti-competitive, and it arguably justifies banning not simply futures trading in individual stocks, but competition from other securities exchanges or the third market, as well.

In short, even if an externality can be plausibly posed, it does not follow that it justifies anti-competitive regulation. In particular, before a purported externality provides an adequate argument for regulatory merger or consolidation, it should be shown that the problem cannot be dealt with adequately by other, less drastic means. For example, the SEC's long-

135. The Sydney Futures Exchange now trades futures on individual stocks. See supra note 96. Although a future on an individual stock resembles an option, options trade on the NYSE, whereas futures do not. Thus, there is the prospect of revenue loss by the NYSE when futures exchanges trade derivatives based on individual securities.

136. For such a view, see Jeffrey N. Gordon, Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice, 76 CAL. L. REV. 1, 60 (1988).
standing opposition to small, non-diversified stock indexes rests on the rationale that they can be used as an imperfect vehicle for insider trading. To be sure, if such indexes can be used for this purpose, the existence of CFTC-approved stock sub-indexes would impose costs on the SEC's enforcement program—and thus constitute an externality. But the simplest answer to this problem is not to bar the new financial product, but to expand the definition of insider trading to cover this context (if indeed any expansion of the law is truly necessary). At most, the SEC needs authority to enforce its insider trading prohibitions in this context, not the much broader authority to bar a rival agency from approving a whole class of potentially marketable financial products.

**ECONOMIES OF SCOPE AND SCALE**

It is comparatively easy to imagine numerous efficiencies that could result from a consolidation of regulatory agencies. For example, a unified system for settlement and clearance of securities, options, and stock index futures transactions could be more easily implemented within a consolidated agency. Net capital rules could also be standardized so that excess capital in the commodities business might be applied to securities operations, or vice versa. In general, for integrated firms active in both the securities and commodities fields, consolidation would imply the harmonization of existing rules so as to simplify and make more uniform the diverse set of rules now applied by each regulator.

Two caveats are necessary here: first, harmonization can be achieved without merger or consolidation (as certainly is happening throughout the Common Market today). Second, some forms of consolidation (such as the CME's proposal) do not necessarily imply harmonization (because both the SEC's and the CFTC's core functions would largely remain in the hands of their existing staffs with higher regulatory approval being necessary from the proposed board of nine FFRS commissioners only in the case of policy changes or new policy initiatives).

The gains from harmonization are likely to vary with the context. Information regulation provides a context where the gains are likely to be small. Although the SEC and the CFTC disclosure systems are very different, so are their users, and firm-specific information is seldom needed

137. Although the CEA, even as amended, only prohibits insider trading in certain limited circumstances, the law of mail and wire fraud has been extended to cover any misappropriation of confidential business information by one standing in a fiduciary relationship to another. See Carpenter v. United States, 484 U.S. 19 (1987).

138. Indeed, the leading examples of success at harmonization, such as the Basle Accord on minimum capital levels for commercial banks and the work of IOSCO on disclosure standards, have come without consolidation or any re-allocation of authority. For a discussion and critique of these attempts at harmonization, see White, *supra* note 8.

139. *See supra* notes 9 & 19-26 and accompanying text.
by the CFTC's constituencies. On the other hand, enforcement activities are likely to benefit substantially from any movement toward consolidation. Particularly in insider trading and market manipulation cases, financial regulators would be better able to reach forms of misbehavior now "underregulated" (for example, intermarket front running, which may today be unlawful, but is seldom enforced, probably due to the difficulty of enforcement) and to economize on enforcement costs generally. Again, however, a caveat is necessary here with respect to specific proposals. Under the CME's proposal, any enforcement recommendation to prosecute "would require the concurrence of each affected division and, unless otherwise determined, Board approval would be required to prosecute." 140

Given the attempt to structure the FFRS as an umbrella agency spanning the entire field of financial regulation, it may not be easy to obtain such approval (even when there is no principled disagreement among the commissioners). Simply assembling nine overworked officials, each with full-time responsibilities in a specialized area, to review pedestrian matters is likely to prove ineffective.

Consolidation does offer one important advantage over the simple transfer of some functions between the CFTC and the SEC. Consider, for example, if jurisdiction over options were transferred to the CFTC, as the CME proposals dictate,141 or conversely, if jurisdiction over stock index futures were given to the SEC, as both the SEC and the Bush administration have proposed in the past, most broker-dealers (in the case of the first proposal) or commodities firms trading these stock index products (in the case of the second proposal) would become subject to the concurrent jurisdiction of both the SEC and the CFTC. This could be the worst of all possible worlds for these firms because it would impose a duplicative and largely redundant regulatory burden with no necessary promise of harmonization to reduce that burden. Indeed, that neither the CBOE nor the Philadelphia Stock Exchange approached the CFTC for permission to trade index participations on their exchanges after losing their legal battle with the CBOT142 evidences this fact.143 The burden of reporting to both the SEC and the CFTC does seem considerable (and competitors on the futures exchanges have every reason to resist attempts to relax that burden). Each agency would conduct its own audits and

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140. Chicago Mercantile Exchange, supra note 9, at 13.
141. Id.
142. See supra notes 81-84 and accompanying text.
143. Phillip M. Johnson, a former CFTC chairman, has stated that the CFTC would have granted permission for trading of an index participation contract subject to its jurisdiction on a securities exchange if application had been made to it. See Johnson, supra note 77. He contends that this failure to apply shows the illusory nature of the stock exchanges' grievances. To the contrary, the author believes that it demonstrates their unwillingness to accept concurrent regulation by the CFTC and the SEC (which, incidentally, would be imposed on them by the CME proposal to the extent that they trade options).
regulatory examinations, require different disclosure documents and licenses, apply different interpretations to the same terms, etc. Ideally, either agency could delegate its jurisdiction to the other agency over firms trading on a kind of exchange (futures or securities) regulated by that agency, but this sensible compromise depends on exactly what proponents of regulatory competition doubt—namely, a non-rivalrous relationship between the two agencies.

EVALUATION AND CONCLUSIONS

Under close analysis, neither the gains from competition nor those from consolidation appear as clear-cut or convincing as their proponents claim. Proponents of the regulatory competition model overstate their case in at least three fundamental ways:

(i) Whatever may be the gains from regulatory competition, they are more likely to be assured by the unavoidable presence of international competition than by any restructuring that is possible at the federal administrative level. At best, competition between the SEC and the CFTC will be imperfect and will always be vulnerable to oligopolistic collusion. For the future, the competitive pressure that U.S. regulators face comes from off-shore and, specifically, from the Asian, Canadian, and European futures markets that have recently eroded the former monopoly enjoyed by U.S. futures exchanges so that U.S. markets today account for only a minority of the world’s volume in futures trading. If regulators, insulated within bureaucracies, can ignore that pressure, they are not likely to be forced into action by the competitive pressure of a domestic rival. If, conversely, they do respond to the international challenge, the gains will be modest from structuring domestic regulation to preserve one additional regulatory rival. Only in the case of inherently local markets (e.g., municipal securities) is domestic regulatory competition likely to play a significant role in promoting efficiency. In short, if (as it appears) competition is breaking out everywhere, the preservation of a costly rivalry between the SEC and the CFTC need not be a priority objective of policy planning.

(ii) Regulatory competition can increase costs as well as benefits. In particular, it tends, in the financial sector, to chill the process of product development. Competing agencies have weapons and can find rationales by which to use those weapons in anti-competitive and retaliatory ways. Thus, in the on-again, off-again conflicts between the SEC and the CFTC, neither side emerges as a hero. Both the CFTC’s success in blocking index participations and the SEC’s victory in barring non-diversified stock indexes are dubious milestones in the history of agency warfare. In the end, the capital markets would be freer and more competitive if both agencies had lost.

144. See supra note 97 and accompanying text.
(iii) Smaller agencies seem more vulnerable to capture. Thus, if policy planning were deliberately to seek to fragment regulatory authority in order to assure competition, it might succeed mainly in facilitating the capture of multiple agencies by interest groups lacking sufficient strength to capture a larger agency with more diverse interests and constituencies. If so, the competition that ensues may serve more to impose a regulatory tax on consumers than to free markets from inefficient constraints.

In turn, the case for regulatory consolidation rests on arguments whose strength varies from context to context. The "race to the bottom" justification is probably weakest when applied at the federal level to support the merger of federal administrative agencies. Externality-based justifications for consolidation can be compelling, but unless one believes that stock index futures imperil the stock exchanges' viability no externality has been identified to date that requires a merger of the CFTC and the SEC. In general, externalities are best prevented by simpler means than agency mergers (for example, by extending the SEC's prohibition against insider trading to stock index futures). Economies of scope and scale exist, but they can be at least partially achieved through regulatory cooperation that falls short of consolidation.

The case for regulatory consolidation is strongest to the extent that the two agencies come to occupy the same (or largely overlapping) terrain. For regulated firms, the best of all worlds is a structure of parallel, non-overlapping agencies that the firms have mobility between, but the worst of all possible worlds is an overlapping structure that both denies them mobility and implies a dual regulatory burden. Today, after the Bankers Trust episode, the over-the-counter derivatives market may be in the process of evolving toward the latter structure.

Where do these abstract comments leave us? Although the case for an SEC/CFTC merger is far from self-evident, the Bankers Trust episode provides the best illustration of the case for consolidation because it leaves two agencies occupying the same field. More generally, the long history of SEC/CFTC rivalry has had anti-competitive consequences (as the sponsors of index participations, Elks, Bounds, non-diversified stock indexes, and other similarly chilled products would probably agree).145 Perhaps, the best argument for consolidation has not yet been noted: if the real competitive pressure is coming from off-shore markets, it may be easier for a consolidated agency to respond to this pressure and negotiate for "harmonized" international standards than for a bifurcated structure to do so.146

145. See supra notes 98-99 and accompanying text.
146. Both the recent GAO report on derivatives and various commentators have called for greater cooperation among financial regulators to respond to international competition and to negotiate "harmonized" standards. Some have explicitly raised the "race to the bottom" theme. See Roger D. Blanc, Policy Issues Presented by Derivatives Trading, INSIGHTs, June 1994, at 10. From this Article's perspective, the validity of this argument depends on whether
In closing, it seems best to come full circle, back to the CME's proposal. What the CME really proposes is less a merger than an enforceable mechanism for harmonization. This seems sensible, but the proposed location of its FFRS in a new cabinet level agency is more questionable. A more likely candidate for such a role is the Federal Reserve Board. As, arguably, the agency within the executive branch historically least subject to capture by special interests, it seems the logical mediator and/or arbiter of inter-agency disputes between the CFTC and the SEC. That the Fed has not been chosen for such a role by the CME may be attributable to its active opposition to CFTC jurisdiction over swaps and OTC derivatives. In any event, given the Federal Reserve Board's apparent success in opposing a Federal Banking Commission last year, it seems unlikely that any reorganization of financial agencies will succeed without its active support. Nor is it likely that the Treasury Department will passively accept its proposed divestiture of the OTC and the OCC.

For all its ingenuity and sophistication, the CME proposal seeks to go a bridge too far. It is novel at a time when health care reform shows that novelty is not necessarily a virtue. It is aggressive, and even predatory, in its attempt to gain jurisdiction over options and swaps for its proposed successor to the CFTC. And it is untested in its unique nine commissioner structure. In this light, one must ask how much would be lost if a much simpler alternative were proposed—namely, conferring a veto power on the Federal Reserve Board over any SEC or CFTC rule that would interfere unreasonably in its discretion with the international competitiveness of U.S. markets or with the ability of U.S. firms to compete in world markets. Under this more modest proposal, the Fed could block new rules of either agency, but could not unravel the existing system of securities and commodities laws (on the ground that this might frustrate the intent of Congress). Such a proposal would give either agency a non-judicial forum in which to make policy arguments against allegedly anti-competitive or jurisdiction-encroaching proposed actions by the other. The Fed could also be instructed to initiate a voluntary program to harmonize the

a true externality can be identified. In some instances, this is easy. For example, a tiny jurisdiction could permit under-capitalized swaps dealers to do business within its territory because the costs of their possible failure would not be felt within the jurisdiction. In other cases it is far harder to identify any "true" externality.

147. See supra note 3 and accompanying text.

148. Of course, what is "unreasonable" depends upon the need for the rule and the likelihood of abuse if the rule is not adopted. Although the author is not proposing a specific balancing test here, the Fed has much experience with "safety and soundness" regulations, and this veto power should extend to cover antifraud rules.

rules of the two agencies and to encourage closer cooperation. Perhaps, also, the chair of each agency could be given a seat on the other.

Such a proposal for arming the Federal Reserve Board with a veto power over rules likely to cause a migration of firms or transactions to foreign markets will be controversial and will have to be carefully tailored and circumscribed to be viable.\textsuperscript{150} Some may feel that the Fed is remote to injured victims, but all too protective to financial institutions seeking regulatory relief. Yet, the agencies have their defenders in the congressional oversight committees, who have in the past zealously defended their agency's jurisdiction (and, by extension, their own political clout). The Fed thus would be likely to succeed in vetoing one agency's rules only when it had the strong support of a rival agency.

The CME's proposal is understandably preoccupied with the decade-long competition between the CFTC and the SEC. But in that sense its proposal is a prisoner of history. For the future, the most important regulatory competition will be at the international level. For several years now, the basic posture of U.S. securities regulators in this competition has been to allow domestic institutional investors and financial firms to escape U.S. regulation,\textsuperscript{151} but to maintain the barricades at their traditional height and to resist any attempt to deregulate, when public investors were involved. This has been sensible, but at some point the globalization of the capital markets will make this an untenable, long-term strategy. Globalization forces regulators to face tougher questions concerning new regulatory initiatives, which may prove too costly because of their likely tendency to drive transactions off-shore. This proposal, that some agency within the Executive Branch monitor these costs, is a suggestion for how to face these tougher questions when they arise, not what any specific outcome should be.

\textsuperscript{150} For example, one might exempt anti-fraud rules from the scope of this veto power.