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

by John C. Coffee, Jr.
Hillary A. Sale*

INTRODUCTION
Symposiums supply a snapshot in time. By observing the common assumptions and shared frameworks of a collection of scholars, writing contemporaneously, one gains both insight into the intellectual world of a past era and the ability to measure its distance from our own. Twenty five years ago the Virginia Law Review organized a noted symposium to celebrate the 50th Anniversary of the SEC (the “1984 Symposium”).¹ A number of prominent scholars participated,² and its articles have been much cited.

Now, we are at it again. Unlike then, however, there is a difference in the mood. The natural superiority of the U.S. model for securities regulation is no

* Adolf A. Berle Professor of Law and F. Arnold Daum Chair in Corporate Finance and Law respectively. The authors wish to thank participants at the Virginia Symposium as well as Jill Fisch and Steve Wallman for their comments. For research assistance, thanks goes to Paul Justensen and Tyler Leavengood.


² In alphabetical order, the participants included Professor Allison Gray Anderson, John C. Coffee, Jr., Frank H. Easterbrook, Daniel R. Fischel, Ronald J. Gilson, Edmund W. Kitch, Reinier H. Kraackman, Saul Levmore and Walter Werner. SEC Chairman John Shad provided the Introduction, and Donald L. Calvin of the New York Stock Exchange also participated.
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longer an article of faith. Rather, much of the world believes they have been caught in a financial crisis because of an illness that began in the U.S. housing market but that has been exported to the rest of the world by U.S.-based financial intermediaries. This article will move from an examination of the SEC’s responsibility for that crisis to a discussion of how financial regulation should be structured for the future.

A quarter century ago, the outlook was more optimistic. The market seemed self-correcting, and the need for regulation was perceived as at most modest. Revealingly, in the 1984 Symposium, little, if anything, was said about globalization or technology (indeed, the Internet was not then known), but these proved to be among the most dynamic and destabilizing forces that have shaped the intervening era. Nor was much attention given to comparative law. The U.S. system of securities regulation was implicitly assumed to be the template for the rest of the world to emulate. Finally, securities regulation was not viewed as part of a broader system of financial regulation, but as an alternative means of influencing corporate governance. Federalism – i.e., the allocation of power between state and federal regulators – received much attention, but not the parallel allocation of authority among federal financial regulators. No one asked: why is it that the SEC is an independent agency and not an arm of the Treasury Department or the Federal Reserve? Today, these ignored issues – globalization, technology, comparative institutional structure, and the place of securities regulation within financial regulation generally – dominate the current discussion.

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


5 Thus, a few years later, Judge Frank Easterbrook, a participant in the 1984 Symposium, declared in an opinion that, because auditors would lose more in reputational capital than they could gain in audit fees from a dishonest client, it would be “irrational for any of them to have joined cause with” such a client. See DiLeo v. Ernst & Young 901 F. 2d 624 (7th Cir. 1990).
market’s efficiency, and, not surprisingly, a major shift towards deregulation was then very much in progress.

So how much distance separates then from now? Today, the bloom is clearly off the rose of finance theory. Intellectual paradigms have shifted over the interim, as a new generation of “behavioral economists” have come to view the ECMH more skeptically, emphasizing in particular the limits of arbitrage. Deregulation is no longer the presumptive policy prescription; indeed today, the sense is growing that the current crisis may have been deepened by excessive deregulation, which a process of international regulatory arbitrage arguably enforced. Similarly, the naiveté behind the view that markets are always quickly self-correcting because of the efforts of reputational intermediaries now seems apparent. “Reputational intermediaries” proved to have their own biases and to be highly vulnerable to issuer pressure. Yet, they remain indispensible because there are simply a number of contexts where investors cannot themselves undertake the verification and evaluative tasks that these experts perform.

Today, we term these specialized intermediaries “gatekeepers,” and their repeated failure has dominated public attention. In 2002, Congress responded to the conflicts surrounding auditors by passing the Sarbanes-Oxley Act, largely to replace private self-regulation of the auditing profession with public regulation. Also in that year, the major investment banks entered into a Global Settlement

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9 See generally John C. Coffee, Jr., GATEKEEPERS: The Professions and Corporate Governance (Oxford University Press 2006).

with the New York State Attorney General, the SEC, and other securities regulators, adopting prophylactic reforms and Chinese Walls to protect the integrity of another gatekeeper, the securities analyst. More recently, the subprime mortgage debacle has amply demonstrated the failure of still another gatekeeper: the credit rating agency. If there is a common theme linking these events, it is probably that self-regulation has severe limitations and seems to work best only when the self-regulator’s duties are clearly demarcated (and it enforces what this article will term “rules” rather than “principles.”)

Viewed panoramically, the most obvious developments over the interval since 1984 have probably been the rapid succession of market crashes and scandals. These seem disproportionate in both frequency and severity to prior periods in U.S. financial history. To be sure, the market crash in 1987 now seems an isolated event that proved little (other than that the unexpected can happen). But repeated waves of scandals have followed: the 2000 Dot.Com crash, the 2001-2002 accounting irregularity scandals that culminated in the bankruptcy of Enron and WorldCom, the New York Attorney General-led investigation of securities analyst conflicts of interest that resulted in a global settlement in 2003, the 2003-2004 “market timing” scandal involving mutual funds, the stock option backdating investigation that began in 2006, and lastly and, most importantly, the current financial crisis that first surfaced in the U.S. housing market in 2007, then spread to derivatives, and has now paralyzed most major financial institutions. All came in rapid succession, revealed pervasive misconduct by “reputational intermediaries,” and have shaken market confidence. If once the rest of the world looked to the SEC for leadership on issues of securities regulation, that presumed leadership is in question today.

A related consequence of these scandals has been that a new layer of financial regulation has developed over the last decade in the United States: state regulators now have become important players in major financial scandals. While state regulators were important prior to the enactment of the federal securities laws, they had become peripheral players by 2000. Their resurgence may have

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11 COFFEE, GATEKEEPERS, supra note 9, at 265–66. New York’s Attorney General Eliot Spitzer discovered widespread abuse of investment bank research analysts’ power. In exchange for more business, these research analysts manipulated their findings to produce favorable ratings for their investment bank clients. Spitzer and his staff discovered internal emails written by research analysts at Merrill Lynch that exposed the fraud. In April 2002, Spitzer settled with Merrill Lynch for $100 million. Soon thereafter, the SEC, NYSE, and NASD investigated other large investment banks and found similar fraud. In April 2003, Spitzer settled with 10 major underwriting firms for $1.3875 billion. Id. See also, Hillary A. Sale, Banks: The Forgotten (?) Partners in Fraud, 73 Cin. L. Rev. 139 (2004) (discussing Spitzer’s role in uncovering the investment banking issues and analyzing the resulting settlements).

12 For a discussion of credit rating agencies as gatekeepers and why they failed, see Coffee, supra note 9, at 34, 283-98.

13 See Howard M. Friedman, The Impact of NSMIA on State Regulation of Broker-Dealers and Investment Advisers, 53 Bus. Law. 511 (1997). The National Securities Markets Improvement Act (NSMIA) significantly impacted the role of federal and state regulators and enforcers in dealing with securities offerings and professionals. Id. at 511. The NSMIA pre-
begun with Eliot Spitzer, but it shows no signs of ending with his political demise. Not surprisingly, the financial industry has not welcomed this new activism by State Attorney Generals and would be happy to constrain or preempt them. Reorganization of financial regulation could provide political cover for legislation curbing the reach of state regulators. But the broader policy question first needs to be addressed: To what extent is competition among regulators desirable?

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

Were there regulatory failures over this time period? Or would any system that stifled the “animal spirits” of the market have involved greater cost? Again, sharp disagreements are inevitable because attitudes toward regulation have polarized since 1984. Until the current crisis struck, critics of regulation had been arguing that the U.S. was losing its capital market competitiveness because it was taking a more aggressive posture towards regulation, and particularly towards enforcement, compared to the other major capital markets. At one pole in this debate, some academics even urged that issuers should be able to choose both the corporate and securities law applicable to them, opting from an inventory that emptied many state regulations and transferred many enforcement responsibilities from the states to the federal government. In states that have not adopted regulations to mirror the NSMIA, for example, state enforcers cannot take any action to prosecute offenders. Instead, they must wait for the SEC or one of the SROs to step in. Id. at 522–23; see also G. Phillip Rutledge, NSMIA…One Year Later: The States’ Response, 53 Bus. Law. 563, 570–74 (1997) (discussing the NSMIA’s impact on states and how states are responding to the new shift in regulatory authority).

There are proposals to this effect in the U.S. Treasury Department’s recent “Blueprint.” See The Department of Treasury, Blueprint for a Modernized Financial Regulatory Structure (2008) at 20 and 172 [hereinafter Treasury Report].

would include at least the corporate and securities laws of the major markets.¹⁶ Such choice, it was argued, would drive a process of regulatory arbitrage until, in theory, the optimal level of regulation was reached. The current crisis is likely to mute this demand for investor choice, because in a world of collapsing and insolvent financial institutions, few favor giving them the right to choose their level of supervision, and regulatory arbitrage inherently reduces the intensity of regulatory oversight. The first lesson of the current crisis is that externalities result when a financial institution fails; hence, shareholders cannot be given unconstrained choice. In turn, a precondition of international competitiveness is that a country’s financial institutions be able to survive a crisis. Conversely, the current crisis also challenges those who favor stronger regulation and enforcement. Why did the crisis begin, and largely devastate the financial landscape, in the United States, which has long had much more aggressive public and private enforcement? If enforcement works, the U.S. should seemingly have been spared.

Both those who favor and those who oppose increased financial regulation can agree on one thing: the current organization of financial regulation in the United States is inefficient or worse. Almost no one likes the status quo. The level of dissatisfaction with the current regulatory model was clearly evidenced by the response to the recent report of the Treasury Department, entitled “Blueprint for a Modernized Financial Regulatory Structure” (the “Blueprint”).¹⁷ The Blueprint recommended both (1) a fundamental reorganization and consolidation of all financial regulators in the United States, and (2) a major shift towards a more deregulatory style that emphasizes reliance on “principles” (rather than “rules”) and self-regulation by the industry. Much like a Rohrsach test, the Blueprint predictably drew mixed and revealing reactions. Few endorsed its specific recommendations; some feared that its proposed reallocation implied the demise of the SEC,¹⁸ but most agreed that it would and should trigger a necessary debate over structural reform. This article analyzes the Blueprint’s proposals, but in terms of its own very different assessment of where financial regulation has gone awry.

The consensus today is that the U.S. has a highly fragmented and arguably Balkanized structure of financial regulation, which approaches creating a different regulator for every class of financial institution. But what feasible alternatives exist? Part I of this article surveys the different patterns of financial regulation

¹⁶ See Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359 (1998). To be sure, Professor Romano does not expressly discuss the special case of financial institutions, but her prescription of investor choice is unqualified, and choice as to disclosure rules is not fundamentally different from choice as to other regulatory regimes.

¹⁷ See The Department of the Treasury, supra note 14.

¹⁸ For such a view, see Julie Satow, “Will Bernanke Doom the SEC?,” New York Sun, July 11, 2008 at p. 1 (expressing view that Federal Reserve oversight of investment banks would eclipse the SEC).
that have recently emerged in the other major capital markets and the failures that sparked these recent changes. Part II will then return to the U.S. and ask a simple but unavoidable question: why have there been so many recent scandals? What failures do they suggest within the U.S. regulatory system? This discussion sets the stage for an examination of the major proposals in the Treasury Department’s Blueprint. Part III will specifically focus on the Blueprint’s proposal that U.S. financial regulation should move to a more “principles-based” system and away from its alleged current fixation on rules. Part IV will similarly examine the Blueprint’s contention that U.S. financial regulation should rely to a greater extent on self-regulation by private bodies, such as stock exchanges, which would adopt rules from broad generic principles promulgated by the securities regulator.

Uniting the Blueprint’s separate strands is a common underlying theme: to maintain U.S. capital market competitiveness, the U.S. should relax its traditionally aggressive enforcement policies, either by relying more on broad principles and self-regulation by the industry, or by delegating at least some aspects of oversight and enforcement to industry self-regulation. This article rejects this argument as unpersuasive and highly ideological; indeed, it views such an attitude as a cause of the current crisis.

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

**Part I: Regulatory Modernization: A Brief Tour of Recent Developments**

Organizationally, financial regulation in the major capital markets today follows one of three basic models:

**A. The Functional/Institutional Model**

The Blueprint repeatedly refers to the United States as having a “current system of functional regulation, which maintains separate regulatory agencies across segregated functional lines of financial services, such as banking,
insurance, securities and futures.”¹⁹ This is at best a partial truth. In fact, the U.S. falls considerably short of even a “functional” regulatory model. By design, “functional” regulation seeks to subject similar activities to regulation by the same regulator. Its premise is that no one regulator can have, or easily develop, expertise in regulating all aspects of financial services. Thus, the securities regulator understands securities, while the insurance regulator has expertise with respect to the very different world of insurance. In the Gramm-Leach-Bliley Act of 1999 (“GLBA”), which essentially repealed the Glass-Steagall Act, Congress endorsed a system of functional regulation in more or less these words.²⁰

Nonetheless, the reality is that the United States actually has a hybrid system of functional and institutional regulation.²¹ The latter approach looks not to functional activity, but to institutional type. Institutional regulation is seldom the product of deliberate design, but rather of historical contingency, piecemeal reform, and gradual evolution.

To illustrate this difference between functional and institutional regulation, let us hypothesize that, under a truly functional system, the securities regulator would have jurisdiction over all sales of securities, regardless of the type of institution selling the security. Conversely, let us assume that under an institutional system, jurisdiction over sales would be allocated according to the type of institution doing the selling. Against that backdrop, what do we observe today about the allocation of jurisdiction? Symptomatically, under a key compromise in GLBA, the SEC did not receive authority to oversee or enforce the securities laws with respect to the sale of government securities by a bank.²² Instead, banking regulators retained that authority. Similarly, the definitions of “broker” and “dealer” in the Securities Exchange Act of 1934 were carefully crafted by GLBA to leave significant bank securities activities under the oversight of bank regulators and not the SEC.²³ Predictably, even in the relatively brief time since the passage of GLBA in 1999, the SEC and bank regulators have engaged in

¹⁹ Blueprint at 4 and 27.
²⁰ The Conference Report to the Gramm-Leach-Bliley Act clearly states this: “Both House and Senate Bills generally adhere to the principle of functional regulation, which holds that similar activities should be regulated by the same regulator. Different regulators have expertise at supervising different activities. It is inefficient and impractical to expect a regulator to have or develop expertise in regulating all aspects of financial services.” See H.R. Rep. No. 106-434, at 157 (1999).
²¹ For this same assessment, see Heidi Mandanis Schooner and Michael Tayler, United Kingdom and States Responses to the Regulatory Challenges of Modern Financial Markets, 38 Tex. Int'l L. J. 317, 328 (2003).
²³ See 15 U.S.C. Section 78(c)(a)(4) and (5).
a continuing turf war over the scope of the exemptions accorded to banks from the
definition of “broker” and “dealer.”

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

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

Turning to securities regulation, one encounters an even more unique
anomaly: the United States has one agency (the SEC) to regulate securities and
another (the Commodities Future Trading Commission) to regulate futures. The
world of derivatives is thus divided between the two, with the SEC having
jurisdiction over options, while still a third category of derivatives – swaps – was
placed by Congress in 2000 largely beyond the reach of both agencies. No other
country does anything like this. Finally, some major areas (for example, insurance)
simply have no federal regulator. By any standard, the United States thus falls
well short of a system of functional regulation.

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

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24 See Kathleen Day, “Regulators Battle Over Banks: Three Agencies Say SEC Rules
down in this particular skirmish and modified its original position. See Securities Exch. Act
25 This is all well described in the Blueprint. See Blueprint at 31-41.
Thus, although the Blueprint proposes that we move beyond functional regulation, the reality is that we are not even there yet, as our existing financial regulatory structure is organized at least as much by institutional category as by functional activity. Disdaining a merely “functional” reorganization under which banking, insurance, and securities would each be governed by their own regulator, the Blueprint instead envisions a far more comprehensive consolidation of all these specialized regulators. Why? In its view, the problems with functional regulation are considerable:

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

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

**B. The Consolidated Financial Services Regulator**

A clear trend is today evident towards the unification of supervisory responsibilities for the regulation of banks, securities markets and insurance. Beginning in Scandinavia in the late 1980s, this trend has recently led the United Kingdom, Japan, Korea, Germany and much of Eastern Europe to move to a single regulator model. Although there are now a number of precedents, the

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26 Blueprint at 4.
27 In particular, the Blueprint hypothesizes that the U.K. has enhanced its own competitiveness by regulatory reforms, adopted in 2000, that are principled-based and rely on self regulation for their implementation. Id. at 3.
30 See Bryan D. Stirewalt & Gary A. Gegenheimer, Consolidated Supervision of Banking Groups in the Former Soviet Republics: A Comparative Examination of the Emerging Trend in
U.K. experience stands out. It was the first major international market center to move to a unified regulator model, and the Financial Services and Markets Act, adopted in 2000, went significantly beyond earlier precedents towards a “nearly universal regulator.” The Blueprint focuses on the U.K.’s experience because it believes that the U.K.’s adoption of a consolidated regulatory structure “enhanced the competitiveness of the U.K. economy.”

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

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

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Emerging Markets, 23 Ann. Rev. Banking & Fin. L. 533 (2004). As discussed later, in some countries (most notably Japan), the change seems more one of form than of substance, with little in fact changing. See Markham, supra note 28, at 383-393 and 396.

31 See Ferran, supra note, at 258.
32 See Schooner and Taylor, supra note 21, at 329. Schooner and Taylor also observe that the precursors to the U.K.’s centralized regulator, which were mainly in Scandinavia, had a “predominantly prudential focus.” Id. at 331. That is, the unified new regulator was more a guardian of “safety and soundness” and less oriented toward consumer protection.
33 Blueprint at 3.
34 Ferran, supra note 28, at 259.
35 Id. at 261-262.
36 Id. at 265.
37 Id. at 266. The most important of these were the Securities and Futures Authority (“SFA”), the Investment Managers’ Regulatory Organization (“IMRO”), and the Personal Investment Authority (“PIA”).
38 Two scandals in particular stood out: the Robert Maxwell affair in which a prominent financier effectively embezzled the pension funds of his companies and a “pension mis-selling”
SROs, acknowledged that self-regulation had failed in the U.K. and seemed unable to restore investor confidence. This acknowledgement set the stage for reform, and when a new Labour Government came into power at the end of the decade, one of its first major legislative acts (as it had promised in its election campaign) was to dismantle the former structure of SROs and replace it with a new and more powerful body, the Financial Services Authority (“FSA”).

Despite the Blueprint’s enthusiasm for the U.K.’s model, the structure that the Blueprint proposes for the U.S. more resembles the former U.K. system than the current one. Under the Blueprint’s proposals, the securities regulator would be restricted to adopting general “principles-based” policies, which would be implemented and enforced by SROs. Arguably, the Blueprint envisions more or less the model that failed in the U.K.

C. The “Twin Peaks” Model

As the Blueprint recognizes, not all recent reforms have followed the U.K. model of a universal regulator. Some nations – most notably Australia and the Netherlands – have instead followed a “Twin Peaks” model that places responsibility for the “prudential regulation of relevant financial institutions” in one agency and supervision of “business conduct and consumer protection” in another. The term “twin peaks” derives from the work of Michael Taylor, a British academic and former Bank of England official. In 1995, just before regulatory reform became a hot political issue in the U.K., he argued that financial regulation had two separate basic aims (or “twin peaks”): (1) “to ensure the soundness of the financial system,” and (2) “to protect consumers from unscrupulous operators.”

Taylor’s work was original less in its proposal to separate “prudential” regulation from “business conduct” regulation than in its insistence upon the need to consolidate responsibility for the financial soundness of all major financial institutions in a single agency. Taylor apparently feared that if the Bank of England remained responsible for the prudential supervision of controversy in which highly risky financial products were inappropriately sold to pension funds without adequate supervision or disclosure. Id. at 267-268.

Id. at 268.

See infra notes 103-105 and accompanying text.

Id. at 3. For a recent discussion of the Australian reorganization, which began in 1996 (and thus preceded the U.K.), see Schooner and Taylor, supra note 21, at 340-341. The Australian Securities and Investments Commission (“ASIC”) is the “consumer protection” agency under this “twin peaks” approach, and the Australian Prudential Regulatory Authority (“APRA”) supervises bank “safety and soundness.” Still, the “twin peaks” model was not fully accepted in Australia as ASIC, the securities regulator, does retain supervisory jurisdiction over the “safety and soundness” of investment banks. Thus, some element of functional regulation remains.


Lichtenstein, supra note 42, at 295.
banks, its independence in setting interest rates might be compromised by its fear that raising interest rates would cause bank failures for which it would be blamed. In part for this reason, the eventual legislation shifted responsibility for bank supervision from the Bank of England to the FSA.

It approaches the self-evident to note that a conflict exists between the consumer protection role of a universal regulator and its role as a “prudential” regulator intent on protecting the safety and soundness of the financial institution. The goal of consumer protection is most obviously advanced through deterrence and financial sanctions, but these can deplete assets and ultimately threaten bank solvency. When only modest financial penalties are used, this conflict may sound more theoretical than real. But, as discussed later, the U.S. is distinctive in the severity of the penalties it imposes on financial institutions. In recent years, the SEC has imposed restitution and penalties exceeding $3 billion annually and private plaintiffs received a record $17 billion in securities class action settlements in 2006. Over a recent ten year period, some 2,400 securities class actions were filed and resulted in settlements of over $27 billion (and attorneys’ fees of approximately $7 billion), with much of this cost (as in the Enron and Worldcom cases) being borne by investment banks. If one agency were seeking both to protect consumers and guard the solvency of major financial institutions, it might find it a very difficult balancing act to achieve both goals and also assure a skeptical public that it had not been “captured” by its regulated firms.

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

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44 See text and notes infra at notes 54 and 95.
45 See Richard Booth, The End of the Securities Fraud Class Action as We Know It, 4 Berkeley Bus. L. J. 1, at *3 (2007).
46 See Financial Services and Markets Act, 2000, c. 8, pt. 1, 6.
47 See Schooner and Taylor, supra note 21, at 335.
48 Id.
49 Id. at 336.
D. A Preliminary Evaluation

Three preliminary conclusions merit emphasis:

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

Second, the Blueprint’s history of recent regulatory reform involves an element of historical fiction. The 2000 legislation in the U.K., which created the FSA as a nearly universal regulator, was not an attempt to introduce self-regulation by SROs (as the Blueprint seems to assume), but a sharp reaction by a Labour Government to the failures of self-regulation. Similarly, Japan’s slow, back-and-forth movement in the direction of a single regulator seems to have been motivated by an unending series of scandals and a desire to give its regulator at least the appearance of being less industry dominated.50

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

Part II: The U.S. Context: Has There Been a Regulatory Failure?

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

50 Japan has a history and a regulatory culture of economic management of its financial institutions through regulatory bodies that is entirely distinct from that of Europe or the United States. Although it has recently created a Financial Services Agency, observers contend that it remains committed to its traditional system of bureaucratic regulation that supports its large banks and discourages foreign competition. See Markham, supra note 28, at 383-393 and 396. Nonetheless, scandals have been the primary force driving institutional change there too, and Japan’s FSA was created at least in part because Japan’s Ministry of Finance (“MOF”) had become embarrassed by recurrent scandals.
How then is the U.S. distinctive? And how should this influence the place of securities regulation within the U.S. regulatory structure? In this section, we briefly survey how the U.S. is different from Europe and then turn to the more controversial topic: what responsibility should the SEC bear for recent scandals and crashes. Here, we write against a backdrop where a legion of “law and economics” scholars have launched tirades of criticism against the Sarbanes-Oxley Act and fulminated generally about the costs of overregulation. Although we do not mean to defend Sarbanes-Oxley against all criticism, we believe the current subprime mortgage meltdown and the resulting “credit crunch” reveal that there are costs to underregulation, and at present these latter costs may be greater.

A. How is the U.S. Different?

Of course, this involves restating some obvious points:

1. The Higher Level of Retail Ownership. Although institutional investors may today dominate trading in the U.S. securities markets, the fact remains that most U.S. households own equity securities, and nearly three-fourths of Americans’ liquid financial assets are invested in securities-related products. This uniquely high level of individual ownership implies both a need for some paternalism in securities regulation and the inevitability that there will be a political demand for strong enforcement. Even the most closely comparable securities market (namely, that of the U.K.) is significantly different. There, securities ownership is much more concentrated in institutions, with a low and declining level of individual ownership. Not surprisingly, when institutions dominate the market, there is less demand for aggressive enforcement (because today’s aggrieved victim may be tomorrow’s defendant). In such an environment, regulators act primarily based on consensus and discipline primarily through “regulatory frowns.”

2. The Tradition of Strong Enforcement. Whether measured in terms of market capitalization or gross domestic product, the disparity between the levels of financial penalties imposed by the SEC versus those imposed by regulators in

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52 As of October 2008, the percentage of shares held by “private investors” (i.e., non-institutional shareholders) in U.K. listed companies had fallen to 9.6% (which was consistent with the level of such ownership in the 1980s, prior to later privatization efforts by the British Government). See Matthew Vincent, “Value of private holdings hits low,” Financial Times, October 19, 2008 at p. 15. At its peak, private ownership hit 20% in 1994. Id. During the 1990s, the level of individual ownership rose as the result of the Thatcher Government’s privatization of government-owned enterprises, but even this 20% level never approached the U.S. level of individual ownership, which has not fallen below 30%. See John Armour & David A. Skeel, Jr., Who Writes the Rules for Hostile Takeovers and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation 50–51 (European Corporate Governance Institute, Working Paper No. 73, 2006), available at http://ssrn.com/abstract=928928 (comparing U.S. and U.K. institutional ownership and revealing U.K. ownership in 2004 approximately 10% higher than U.S.).
other major capital markets is extraordinary. In recent years, the SEC has obtained penalties or financial restitution from defendants in amounts exceeding $3 billion per year. In sharp contrast, the U.K.’s FSA imposed fines of only 5.3 million pounds in 2007, down from 13.3 million pounds in 2006. Thus, comparing the SEC to its most closely comparable regulator, the FSA, the ratio in recoveries seems to be nearly 300 to 1 in 2007 and probably around 100 to 1 for most recent years. Moreover, the SEC is only one of several public enforcers in the U.S. (FINRA and the states also impose large penalties and obtain settlements). Finally, private enforcement obtains greater recoveries than public enforcement. For example, in 2006, securities class action settlements peaked at over $17 billion. Criminal enforcement of securities fraud cases is similarly common in the U.S. and virtually unknown in Europe (in 2008, FSA brought the first criminal cases for insider trading in its history).

Why does the U.S. display such greater enforcement intensity? The answer may lie in its higher level of retail ownership (and a resulting greater political demand for enforcement), or it may lie historically in the traditional Populist skepticism of Wall Street, which goes back at least to the late 19th Century (and possibly earlier). Curiously, the enforcement disparity seems to be growing, even as U.S. and European corporate governance appear to be converging in other respects.

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

3. Equity Compensation. During the 1980s, the U.S. moved almost overnight from a system in which senior managers were primarily compensated in cash to one in which they were primarily compensated in equity (through stock options). This change was partly driven by tax considerations and partly by institutional investor pressure (as the institutions believed that senior management was often too indifferent to their firm’s stock price). Whatever the reason, the result was that corporate governance in the U.S. now uses a very high octane fuel to incentivize managers. As a result, there may be far greater reason for senior management in U.S. companies to seek to inflate earnings or understate liabilities.


55 See Jonathan Sibun, “Tough-Talking Regulator Hands Out Smaller Fines,” The Sunday Telegraph, December 30, 2007; “Watchdog Fines at Six-Year Low, as City Keeps to Rules,” Yorkshire Post, December 31, 2007. The average fine in 2007 was 232,000 pounds and only one fine was over one million pounds.
than for their counterparts in Europe to do so. This may be the common denominator that best links the stock market scandals of 2001-2002 that led to the Sarbanes-Oxley Act with the debt markets crisis of 2008. Indeed, this phenomenon of a compensation system that engenders a short-term orientation is particularly strong within the finance industry where the combination of stock options plus annual cash bonuses in the millions of dollars gives rise to extraordinary pressures on managers to close deals at all costs. Arguably, senior executives of U.S. financial institutions opted for higher levels of leverage over the last decade, both because it enhanced short-term profitability and because a risk-neutral stock market tolerated, and even demanded, acceptance of higher levels of risk – even as the brink of insolvency was neared.

The ability of senior management in U.S. companies to pursue higher risk policies follows not only from the differences in compensation but also from differences in the structure of share ownership. Europe is characterized by concentrated ownership; the U.S., by dispersed ownership and what Berle and Means called the “separation of ownership and control.” In a concentrated ownership system, the controlling owners are not diversified, and they can and do monitor management, whereas in a dispersed ownership system, dispersed shareholders are both more diversified and less able to monitor or constrain management. Possibly because there are significant limitations on the ability of dispersed shareholders to monitor, greater investment in public enforcement is necessary to keep agency costs under control. Equally important, in a concentrated ownership system, controlling shareholders generally have little incentive to maximize the day-to-day stock price of their firm. Unlike managers in a dispersed ownership system, they cannot simply exercise stock options and dump the stock into the market, because by definition they hold large and illiquid blocks and do not wish to increase their already undiversified position. Nor is it likely that controlling shareholders plan to sell in the short-term. Even when they do wish to sell, they will typically do so in privately negotiated control sales to an incoming controlling shareholder at a premium that is not closely related to the market price. For all these reasons, while controlling shareholders may overreach, they typically have little reason to engage in short-term market manipulation.

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

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

Where did the crisis begin? Although the deeper origins of the 2008 financial meltdown may lie in deregulatory measures, taken both by Congress and the SEC, that placed some categories of derivatives and some entities beyond effective regulation, most accounts start by describing the rapid inflation of a bubble in the U.S. housing market. But the term “bubble” can be a substitute for closer analysis and may carry a misleading connotation of inevitability. In truth, bubbles fall into two basic categories: those that are demand-driven and those that are supply-driven. Most bubbles fall into the former category, but the 2008 financial market meltdown was clearly a supply-driven bubble, fueled by the fact that mortgage loan originators had come to realize that underwriters were increasingly willing to buy portfolios of mortgage loans for asset-backed securitizations without seriously investigating the underlying collateral.

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

Even more striking, however, is their finding that the rate of mortgage defaults was highest in those neighborhoods that had the highest rates of securitization. Not only did securitization correlate with a higher rate of default, but that rate of default was highest when the mortgages were sold by the loan

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57 Interestingly, this is the diagnosis that SEC Chairman Christopher Cox recently presented to the Senate Banking Committee. See text and notes infra at notes 90 to 91. He stressed the failure of Congress to give the SEC jurisdiction over investment bank holding companies or over-the-counter derivatives (including credit default swaps).

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


60 Id. at 11 to 13.
61 Id. at 18-19.
62 Id. at 19.
63 Id. at 20-21.
originator to financial firms unaffiliated with the loan originator. 64 Other researchers have reached a similar conclusion: conditional on being securitized, a loan portfolio that is more likely to be securitized defaults by about 20% more than a similar risk profile loan portfolio that is less likely to be securitized. 65 Why? The most plausible interpretation is that securitization adversely affects the incentives of lenders to screen their borrowers.

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

- a breakdown in underwriting standards for subprime mortgages;
- a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors, related in part to failures to provide or obtain adequate risk disclosures;
- flaws in credit rating agencies’ assessment of subprime residential mortgages . . . and other complex structured credit products, . . .
- risk management weaknesses at some large U.S. and European financial institutions; and
- regulatory policies, including capital and disclosure requirements, that failed to mitigate risk management weaknesses.” 66

Correct as the President’s Working Group was in noting the connection between the decline of discipline in the mortgage loan origination market and a similar laxity among underwriters in the capital markets, it largely ignored the direction of the causality. In retrospect, irresponsible lending in the mortgage market appears to have been a direct response to the capital markets’ increasingly insatiable demand for financial assets to securitize. If underwriters were willing to rush deeply flawed asset-backed securitizations to the market, mortgage loan originators had no rational reason to resist them.

64 Id.
Thus, the real mystery is not why loan originators made unsound loans, but why underwriters bought them. Anecdotal evidence suggests that due diligence efforts within the underwriting community slackened in asset-backed securitizations after 2000.\textsuperscript{67} Others have suggested that the SEC contributed to this decline by softening its disclosure and due diligence standards for asset-backed securitizations,\textsuperscript{68} in particular by adopting in 2005 Regulation AB, which covers the issuance of asset backed securities.\textsuperscript{69} At this point, it becomes plausible that failures in regulatory oversight, including by the SEC, may have played a greater causal role in the debacle than has been generally emphasized (even if the SEC had no responsibility or capacity to monitor the mortgage loan origination process).

Still, any inquiry into why underwriters bought risky loan portfolios without adequate due diligence or why the SEC narrowly defined the disclosure obligations of issuers in securitizations defines the problem too narrowly. The danger here is that one may “miss the forest for the trees.” If one takes instead a broader “before and after” perspective, the most striking fact about this crisis is that the United States, as of the beginning of 2008, had five major investment banks that were not owned by a larger commercial bank: Merrill Lynch, Goldman Sachs, Morgan Stanley, Lehman Brothers and Bear Stearns. By the late Fall of 2008, all of these investment banks had either failed or abandoned their status as independent investment banks. Two (Bear Stearns and Merrill Lynch) had been forced at the brink of insolvency to merge with larger commercial banks in transactions orchestrated by banking regulators. One – Lehman Brothers – had filed for bankruptcy, and the two remaining investment banks – Goldman Sachs and Morgan Stanley – had converted into bank holding companies under pressure.

\textsuperscript{67} Investment banks formerly relied on “due diligence” firms that they employed to determine whether the loans within a loan portfolio were within standard parameters. These firms would investigate and inform the underwriter as to the percentage of the loans that were “exception” loans (i.e., loans outside the investment bank’s normal guidelines). Subsequent to 2000, the percentage of “exception loans” in portfolios securitized by these banks often rose from the former level of 25% to as high as 80%. Also, the underwriters scaled back the intensity of the investigations that they would authorize the “due diligence” firm to conduct, reducing from 30% to as few as 5% the number of loans in a portfolio that it was to check. See Vikas Bajaj & Jenny Anderson, “Inquiry Focuses on Withholding of Data on Loans,” N.Y. Times, January 12, 2008 at p. A-1.


\textsuperscript{69} See Securities Act Release No. 8518 (“Asset-Backed Securities”) (January 7, 2005), 79 FR 1506). Regulation AB codified a series of “no action” letters and established disclosures standards for all asset-backed securitizations. See 17 C.F.R. §§ 229.1100-1123 (2005). Although it did not represent a sharp deregulatory break with the past, Regulation AB did reduce the due diligence obligation of underwriters by eliminating any need to assure that assets included in a securitized pool were adequately documented. Professor Mendales has pointed out that government sponsored entities, such as Ginny Mae, had required such documentation. See Mendales, supra note 68, at 36. His point is that Regulation AB should have adopted the procedures used by housing-related GSEs, such as Ginny Mae, which mandated quality control procedures. Id.
from the Federal Reserve Bank, thus moving from SEC to Federal Reserve supervision.\textsuperscript{70} Each of these firms had survived prior recessions, market panics, and repeated turmoil and had long histories extending back as far as the pre-Civil War era. Yet, each either failed or was gravely imperiled within the same basically six month period following the collapse of Bear Stearns in March 2008.

If their uniform collapse was not enough to suggest the possibility of regulatory failure, one additional common fact unites them: each of these five firms voluntarily entered into the SEC’s Consolidated Supervised Entity (“CSE”) Program, which was established by the SEC in 2004 for only the largest investment banks.\textsuperscript{71} Indeed, these five investment banks were the only investment banks permitted by the SEC to enter the CSE program. A key attraction of the CSE Program was that it permitted its members to escape the SEC’s traditional net capital rule, which placed a maximum ceiling on their debt to equity ratios, and instead elect into a more relaxed “alternative net capital rule” that contained no similar limitation.\textsuperscript{72} The result was predictable: all five of these major investment banks increased their debt-to-equity leverage ratios significantly in the period following their entry into the CSE Program, as shown by Figure 1 below:\textsuperscript{73}

\textsuperscript{70} For a concise overview of these developments, see Jon Hilsenrath, Damian Palette, and Aaron Lucchetti, “Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis,” The Wall Street Journal, September 22, 2008 at p. A-1 (concluding that independent investment banks could not survive under current market conditions and needed closer regulatory supervision to establish credibility).


\textsuperscript{72} The SEC’s “net capital rule,” which dates back to 1975, governs the capital adequacy and aggregate indebtedness permitted for most broker-dealers. See Rule 15c3-1 (“Net Capital Requirements for Brokers and Dealers”). 17 C.F.R. § 240.15c3-1. Under subparagraph (a)(1)(i) of this rule, aggregate indebtedness is limited to fifteen times the broker-dealer’s net capital; a broker-dealer may elect to be governed instead by subparagraph (a)(1)(ii) of this rule, which requires it maintain its net capital at not less than the greater of $250,000 or two percent of “aggregate debit items” as computed under a special formula that gives “haircuts” (i.e., reduces the valuation) of illiquid securities. Both variants place fixed limits on leverage.

That higher leverage, coupled with a high concentration of their assets in subprime mortgages and related real estate assets, left them exposed and vulnerable when market conditions soured in 2007-2008. For example, at the time of its insolvency, Bear Stearns’ gross leverage ratio had hit 33 to 1.\footnote{See SEC Inspector General Report at 19.}

These facts may seem to corroborate a now popular hypothesis: excessive deregulation by the SEC caused the liquidity crisis that swept the global markets in 2008.\footnote{For the strongest statement of this thesis, see Stephen Labaton, “S.E.C. Concedes Oversight Plans Fueled Collapse,” New York Times, September 27, 2008 at p. 1. Nonetheless, this analysis is oversimple. Although SEC Chairman Cox did indeed acknowledge that there were flaws in the “Consolidated Supervised Entity” Program, he did not concede that it “fueled” the collapse or that it represented deregulation. As discussed below, the SEC probably legitimately believed that it was gaining regulatory authority from the CSE Program (but it was wrong).} The problem with this simple hypothesis is that it is just too simple. Deregulation may well have contributed to the 2008 financial crisis, but the SEC’s adoption of the CSE Program in 2004 was not intended to be deregulatory. Rather, the program was intended to compensate for earlier deregulatory efforts by Congress that had left the SEC unable to monitor the overall financial position and risk management practices of the nation’s largest investment banks. Still, if the 2004 net capital rule changes were not intended to be deregulatory, they worked out that way in practice. The ironic bottom line is that the SEC unintentionally deregulated by introducing an alternative net capital rule that it could not effectively monitor.
The events leading up to the SEC’s decision to relax its net capital rule for the largest investment banks began in 2002, when the European Union adopted its Financial Conglomerates Directive. The main thrust of the E.U.’s new directive was to require regulatory supervision at the parent company level of financial conglomerates that included a regulated financial institution (e.g., a broker-dealer, bank or insurance company). The E.U.’s entirely reasonable fear was that the parent company might take actions that could jeopardize the solvency of the regulated subsidiary. The E.U.’s directive potentially applied to the major U.S. investment and commercial banks because all did substantial business in London (and elsewhere in Europe). But the E.U.’s directive contained an exemption for foreign financial conglomerates that were regulated by their home countries in a way that was deemed “equivalent” to that envisioned by the directive. For the major U.S. commercial banks (several of which operated a major broker-dealer as a subsidiary), this afforded them an easy means of avoiding group-wide supervision by regulators in Europe, because they were subject to group-level supervision by U.S. banking regulators. But U.S. investment banks had no similar escape hatch, as the SEC had no similar oversight over their parent companies. Thus, fearful of hostile regulation by some European regulators, U.S. investment banks lobbied the SEC for a system of “equivalent” regulation that would be sufficient to satisfy the terms of the directive and give them immunity from European oversight. For the SEC, this offered a serendipitous opportunity to oversee the operations of investment bank holding companies, which authority the SEC had sought for some time. Following the repeal of the Glass-Steagall Act, the SEC had asked Congress to empower it to monitor investment bank holding companies, but it had been rebuffed. Thus, the voluntary entry of the holding companies into the Consolidated Supervised Entity program must have struck the SEC as a welcome development, and Commission unanimously approved the program without any partisan disagreement.

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

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


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

Why did the SEC allow the major investment banks to elect into an alternative regime that placed no outer limit on leverage? Most likely, the Commission was principally motivated by the belief that it was only emulating the more modern and advanced “Basel II” standards used by the Federal Reserve Bank. To be sure, the investment banks undoubtedly knew that adoption of Basel II standards would permit them to increase leverage (and they lobbied hard for such a change). From the SEC’s perspective, however, it designed the CSE Program to be broadly consistent with the Federal Reserve’s oversight of bank holding companies, and it even incorporated the same capital ratio that the Federal Reserve mandated for bank holding companies. In addition, the CSE Program required its participants to maintain “tentative net capital” of at least $1 billion and to notify the Commission if tentative net capital fell below $5 billion. The difference may seem modest; the SEC may have been overreached, but it was not “captured.” Still, this difference goes to the agency’s integrity.

So what went wrong? The SEC’s Inspector General examined the failure of Bear Stearns and the SEC’s responsibility therefor and reported that Bear Stearns had remained in compliance with the CSE Program’s rules at all relevant times. Thus, if Bear Stearns had not cheated, this implied (as the Inspector General found) that the CSE Program, itself, had failed. That seems fair enough, but this conclusion still does not mean that the retention of the standard net capital rule (with its 15:1 debt to net capital ratio) would have saved any of the CSE Program’s investment banks from the liquidity crisis that enveloped them. A close reading of the Inspector General’s report suggests that the real problem lay less in the specific terms of CSE’s Program’s rules than in SEC’s staff inability to monitor the participating investment banks closely or to demand specific actions.

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80 See Rule 15c3-1(a)(1)(i) (“Alternative Indebtedness Standard”), 17 C.F.R. § 240.15c3-1(a)(1).
81 See Rule 15c3-1(a)(1)(ii) (“Alternative Standard”), 17 C.F.R. § 240.15c3-1(a)(1)(ii). This alternative standard is framed in terms of the greater of $250,000 or two percent, but for any investment bank of any size, two percent will be the greater. Although this alternative standard may sound less restrictive, it was implemented by a system of “haircuts” that wrote down the value of investment assets to reflect their illiquidity.
82 See SEC Inspector General Report at 10-11. Under these standards, a “well-capitalized” bank was expected to maintain a 10 percent capital ratio. Id. at 11. Nonetheless, others have argued that Basel II “was not designed to be used by investment banks” and that the SEC “ought to have been more careful in moving banks on to the new rules.” See “Mewling and Puking: Bank Regulation,” The Economist, October 25, 2008 (U.S. Edition).
83 Id. at 11.
84 Id. at 10.
by them. Basel II’s approach to the regulation of capital adequacy at financial institutions contemplated close monitoring and supervision. Thus, the Federal Reserve assigns members of its staff to maintain an office within a regulated bank holding company in order to provide constant oversight. In the case of the SEC, a team of only three SEC staffers were assigned to each CSE firm (and a total of only thirteen individuals comprised the SEC’s Office of Prudential Supervision and Risk Analysis that oversaw and conducted this monitoring effort). From the start, it was a mismatch: three SEC staffers to oversee an investment bank the size of Merrill Lynch, which could easily afford to hire scores of highly quantitative economists and financial analysts, implied that the SEC was simply outgunned.

This mismatch was compounded by the inherently individualized criteria upon which Basel II relies. Instead of applying a uniform standard (such as a specific debt to equity ratio) to all financial institutions, Basel II contemplated that each regulated financial institution would develop a computer model that would generate risk estimates for the specific assets held by that institution and that these estimates would determine the level of capital necessary to protect that institution from insolvency. Thus, using the Basel II methodology, the investment bank generates a mathematical model that crunches historical data to evaluate how risky its portfolio assets were and how much capital it needed to maintain to protect them. Necessarily, each model was ad hoc, specifically fitted to that specific financial institution. But no team of three SEC staffers was in a position to contest these individualized models or the historical data used by them. Thus, the impact of the Basel II methodology was to shift the balance of power in favor of the management of the investment bank and to diminish the negotiating position of the SEC’s staff. The problem was less that Basel II’s criteria were inherently flawed than that it was a sophisticated tool that was beyond the capacity of the SEC’s largely legal staff to administer effectively.

The SEC’s Inspector General’s Report bears out this critique by describing a variety of instances surrounding the collapse of Bear Stearns in which the SEC’s staff did not respond to red flags that the Inspector General, exercising 20/20 hindsight, considered to be obvious. The Report finds that although the SEC’s staff was aware that Bear Stearns had a heavy and increasing concentration in mortgage securities, it “did not make any efforts to limit Bear Stearns mortgage securities concentration.” In its recommendations, the Report proposed both that the staff become “more skeptical of CSE firms’ risk models” and that it “develop

85 Id. at 2.
86 Id. Similarly, the Office of CSE Inspectors had only seven staff. Id.
87 Moreover, the process effectively ceased to function well before the 2008 crisis hit. After SEC Chairman Cox re-organized the CSE review process in the Spring of 2007, the staff did not thereafter complete “a single inspection.” See Labaton, supra note 78.
88 Id. at ix.
additional stress scenarios that have not already been contemplated as part of the prudential regulation process.\(^{89}\)

But is this proposal realistic? Can the SEC’s staff really hope to regulate through gentle (or even less-than-gentle) persuasion? Unlike a prophylactic rule (such as the SEC’s traditional net capital rule that placed a uniform ceiling on leverage for all broker-dealers), the identification of “additional stress scenarios” by the SEC’s staff does not necessarily lead to specific actions by the CSE firms; rather, such attempts at persuasion are more likely to produce an extended dialogue, with the SEC’s staff being confronted with counter-models and interpretations by the financial institution’s managers.

Our sense that the SEC cannot negotiate successfully for voluntary compliance in an area where the investment banks have strong economic interests is confirmed by a similar assessment from the person with perhaps the most recent experience in this area. In his September, 2008 testimony before a Senate committee, SEC Chairman Christopher Cox emphasized the infeasibility of voluntary compliance, expressing his frustration with attempts to negotiate issues such as leverage and risk management practices with the CSE firms. In a remarkable statement for a long-time proponent of deregulation, he testified:

“[B]eyond highlighting the inadequacy of the . . . CSE program’s capital and liquidity requirements, the last six months – during which the SEC and the Federal Reserve worked collaboratively with each of the CSE firms . . . – have made abundantly clear that voluntary regulation doesn’t work.”\(^{90}\)

His point was that the SEC had no inherent authority to order a CSE firm to reduce its debt to equity ratio or to keep it in the CSE Program.\(^{91}\) If it objected, a potentially endless regulatory negotiation might only begin.

Ultimately, even if one absolves the SEC of “selling out” to the industry in adopting the CSE Program in 2004, it is still clear at a minimum that the SEC

\(^{89}\) Id. at xi.

\(^{90}\) See Testimony of SEC Chairman Christopher Cox before the Committee on Banking, Housing, and Urban Affairs, United States Senate, September 23, 2008 (“Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions”), at p. 4 (available at www.sec.gov) (emphasis added). Chairman Cox has repeated this theme in a subsequent Op/Ed column in the Washington Post, in which he argued that “Reform legislation should steer clear of voluntary regulation and grant explicit authority where it is needed.” See Christopher Cox, “Reinventing A Market Watchdog,” The Washington Post, November 4, 2008 at A-17.

\(^{91}\) Chairman Cox added in the next sentence of his Senate testimony: “There is simply no provision in the law authorizes the CSE Program, or requires investment bank holding companies to compute capital measures or to maintain liquidity on a consolidated basis, or to submit to SEC requirements regarding leverage.” Id. This is true, but if a CSE firm left the CSE program, it would presumably become subject to European regulation; thus, the system was not entirely voluntary and the SEC might have used the threat to expel a non-compliant CSE firm.
lacked both the power and the expertise to restrict leverage by the major investment banks, at least once the regulatory process began with each bank generating its own risk model. Motivated by stock market pressure and the incentives of a short-term oriented executive compensation system, senior management at these institutions affectively converted the process into self-regulation.

One last factor also drove the rush to increased leverage and may best explain the willingness of some investment banks to relax their due diligence standards: competitive pressure and the need to establish a strong position in a new and expanding market. For the major players in the asset-backed securitization market, the long-term risk was that they might be cut off from their source of supply, as loan originators were acquired or entered into long-term relationship with competitors. Needing an assured source of supply, some investment banks (most notably Lehman and Merrill, Lynch) invested heavily in acquiring loan originators and related real estate companies, thus in effect vertically integrating. In so doing, they assumed even greater risk by increasing their concentration in real estate and thus their undiversified exposure to a downturn in that market. This need to stay at least even with one’s competitors best explains the now famous line uttered by Charles Prince, the then CEO of Citigroup in July, 2007, just as the debt market was beginning to collapse. Asked by the Financial Times if he saw a liquidity crisis looming, he answered:

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

In short, competition among the major investment banks can periodically produce a mad momentum that sometimes leads to a lemmings-like race over the cliff. This in essence had happened in the period just prior to the 2000 dot.com bubble. See Terry Pristin, “Risky Real Estate Deals Helped Doom Lehman,” N.Y. Times, September 17, 2008 at C-6 (discussing Lehman’s expensive, multi-billion dollar acquisition of Archstone-Smith); Gretchen Morgenson, “How the Thundering Herd Faltered and Fell,” N.Y. Times, November 9, 2008 at B4-1 (analyzing Merrill Lynch’s failure and emphasizing its acquisitions of loan originators).


93 Although a commercial bank, Citigroup was no exception this race, impelled by the high fee income it involved. From 2003 to 2005, “Citigroup more than tripled its issuing of C.D.O.s to more than $30 billion from $6.28 billion. . . .” See Eric Dash and Julie Creswell, “Citigroup Pays for a Rush to Risk” N.Y. Times, November 22, 2008 at 1, 34. In 2005 alone, the New York Times estimates that Citigroup received over $500 million in fee income from these C.D.O. transactions. From being the sixth largest issuer of C.D.O.s in 2003, it rose to being the largest C.D.O. issuer worldwide by 2007, issuing in that year some $49.3 billion out of a worldwide total of $442.3 billion (or slightly over 11% of the world volume). Id. at 35.

What motivated this extreme risk-taking? Certain of the managers running Citigroup’s securitization business received compensation as high as $34 million per year (even though they
bubble, and again during the accounting scandals of 2001-2002, and this process repeated itself during the subprime mortgage debacle. Once the market becomes hot, the threat of civil liability – either to the SEC or to private plaintiffs in securities class actions – seems only weakly to constrain this momentum. Rationalizations are always available: “real estate prices never fall;” “the credit rating agencies gave this deal a ‘Triple A’ rating,” etc. Explosive growth and a decline in professional standards often go hand in hand. Here, after 2000, due diligence standards appear to have been relaxed, even as the threat of civil liability in private securities litigation was growing.95

As an explanation for an erosion in professional standards, competitive pressure applies with particular force to those investment banks that saw asset-back securitizations as the core of their future business model. In 2002, a critical milestone was reached, as in that year the total amount of debt securities issued in asset-backed securitizations equaled (and then exceeded in subsequent years) the total amount of debt securities issued by public corporations.96 Debt securitizations were not only becoming the leading business of Wall Street, as a global market of debt purchasers was ready to rely on investment grade ratings from the major credit rating agencies, but they were particularly important for the independent investment banks in the CSE Program. Although all underwriters anticipated high rates of return from securitizations, the independent underwriters had gradually been squeezed out of their traditional line of business – underwriting corporate securities – in the wake of the step-by-step repeal of the Glass-Steagall Act. Beginning well before the formal repeal of that Act in 1999, the major commercial banks had been permitted to underwrite corporate debt securities and had increasingly exploited their larger scale and synergistic ability to offer both bank loans and underwriting services to gain an increasing share of this underwriting market. Especially for the smaller investment banks (e.g., Bear Stearns and Lehman), the future lay in new lines of business, where, as nimble and adaptive competitors, they could steal a march on the larger and slower commercial banks. To a degree, both did, and Merrill eagerly sought to follow in

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

96 For a chart showing the growth of asset-backed securities in relation to conventional corporate debt issuances over recent years, see J. Coffee, J. Seligman, and H. Sale, SECURITIES REGULATION: Case and Materials (10th ed. 2006) at p. 10.
their wake.97 To stake out a dominant position, the CEOs of these firms adopted a “Damn-the-torpedoes-full-speed-ahead” approach that led them to make extremely risky acquisitions. Their common goal was to assure themselves a continuing source of supply of subprime mortgages to securitize, but in pursuit of this goal, both Merrill Lynch and Lehman made risky acquisitions, in effect vertically integrating into the mortgage loan origination field. These decisions, plus their willingness to acquire mortgage portfolios well in advance of the expected securitization transaction, left them undiversified and exposed to large writedowns when the real estate market soured.

So where does this brief history leave us? Our contention is not that excessive leverage and inadequate risk management policies were the sole causes of the 2008 financial crisis. Much blame can also be fairly assigned to other culpable parties, including the credit rating agencies and the Congress for deregulating over-the-counter derivatives in 2000.98 Nor were the investment banks alone in pursuing high leverage and de-emphasizing risk management practices. The private equity firms and some hedge funds also experienced a similar bubble and may yet in some cases face insolvency.99 But the unique fact about financial institutions in general, and investment banks in particular, is their fragility. They finance their business using short-term capital to hold long-term illiquid assets. This mismatch exposes investment banks to liquidity crises, and, as the crisis mounts, their counter-parties back away and refuse to trade with them. This has happened before cyclically, well within the memory of the chief executives running these institutions.100 Then as now, the SEC was not effective in dealing with this problem.

97 For a detailed description of Merrill, Lynch’s late entry into the asset-backed securitization field and its sometimes frenzied attempt to catch up with Lehman by acquiring originators of mortgage loans, see Gretchen Morgenson, “How the Thundering Herd Faltered and Fell,” N.Y. Times, November 9, 2008, at BU-1. Merrill eventually acquired an inventory of $71 billion in risky mortgages, in part through acquisitions of loan originators. By mid-2008, an initial writedown of $7.9 billion forced the resignation of its CEO. As discussed in this New York Times article, loan originators dealing with Merrill believed it did not accurately understand the risks of their field. For Lehman’s similar approach to acquisitions of loan originators, see text and note, supra, at note 92.

98 The Commodities Futures Modernization Act of 2000 (“CFMA”) largely withdrew swaps and other over-the-counter derivatives from the regulatory jurisdiction of both the SEC and the Commodities Futures Trading Commission (although both retained anti-fraud jurisdiction).


100 In 1990, Drexel Burnham Lambert Group, Inc., the parent company in a financial conglomerate that included a large broker-dealer subsidiary, encountered a financial crisis and became unable to roll over its commercial paper and its counterparties similarly declined to trade with it. Its bankruptcy (and that of its broker dealer subsidiary) led Congress to enact the Market Reform Act of 1990 to add Section 17(b) to the Securities and Exchange Act of 1934. For a review of this last major broker-dealer insolvency before the current crisis, see U.S. Securities and Exchange Commission, Office of the Inspector General, “SEC’s Oversight of Bear Stearns and
Others have suggested that SEC deregulation also resulted in inadequate disclosure and insufficient due diligence. Here, we are less certain whether abbreviated disclosure played a significant causal role, but relaxed due diligence was symptomatic of this era. Even if we give the SEC the benefit of the doubt on this score, the conclusion still seems inescapable that the SEC was an ineffective monitor of leverage and risk management policies at financial institutions under its jurisdictions, from at least the time of the Drexel Burnham bankruptcy in 1990 through the current crisis. Equally important, a major reason for its failure, as SEC Chairman Cox has proclaimed, was the SEC’s need to rely on “voluntary” cooperation and engage in extended negotiations with the investment banks over an issue that was central to these banks’ profitability. This is hardly an endorsement for the Blueprint’s call for greater self-regulation.

Perhaps, this may seem an academic criticism because the CSE Program is today moribund, and the remaining investment banks have reconstituted themselves as bank holding companies. But, for the future, the critical issue is what agency or agencies should supervise hedge funds, insurance companies, and other financial institutions that are “too big to fail.” Inherently, this involves two issues: (1) Who should monitor the safety and soundness of these institutions – the SEC or the Federal Reserve?; and (2) What role can safely be given to industry self-regulation? Against this backdrop, we turn next to the Treasury’s proposals.

**Part III: Can Principles Replace Rules?**

Recent discussions about reforming the SEC, including the Blueprint, have been laced with earnest invocations of the superiority of “principles” as a basis for any regulatory reform and a corresponding denigration of “rules-based” regulation. The Blueprint stresses that a quick change to a principles-oriented

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Related Entities: Broker-Dealer Risk Assessment Program (Report No. 446-B September 25, 2008) at 1. The foregoing SEC Inspector General’s Report found the Commission to have poorly implemented the Broker-Dealer Risk Assessment Program that had been established pursuant to § 17(b) in response to the Drexel bankruptcy.

101 For this view, see Richard Mendales, supra note 68. Professor Mendales argues convincingly that (1) the focus of disclosure should be on the quality of the collateral in the securitized pool, not on the historical returns on mortgages, and (2) underwriters should be required to perform sufficient due diligence to document all the loans in the pool. Regulation AB did neither.

102 See text and notes supra at notes 90 to 91.

system is vital to maintaining global competitiveness.\textsuperscript{104} The financial industry generally agrees.\textsuperscript{105} Accordingly, this section reviews the literature on the principles versus rules debate. Not surprisingly, we conclude, first, that our current system maintains a subtler balance between the two than has generally been recognized and, second, that without rules, enforcement, and any sense of parity therein, would decline in ways that business would actually find unpalatable.

The standard analysis – both legal and economic – has long recognized that a principles-based system of regulation is broader and more fluid than its rules-based counterpart. Where a rule delineates, \textit{ex ante}, allowed conduct, a principle provides a more general description of acceptable conduct.\textsuperscript{106} The regulator charged with enforcing the principle decides, \textit{ex post}, whether particular conduct is acceptable and whether the conduct in question violates the principle.\textsuperscript{107}

This balance between the \textit{ex ante} decision under a rule-based regime and the \textit{ex post} decision under a principle-based system is best illustrated by using the example of alternative ways to regulate speed limits.\textsuperscript{108} A speed limit crafted as a rule might prohibit driving above 70 miles an hour. Anyone who does so breaks


\textsuperscript{107} Kaplow, \textit{supra} note 106, at 560.

\textsuperscript{108} Almost all commentators seem to have used this example. See Kaplow, \textit{supra} note 106 at 559-61; Christie L. Ford, \textit{New Governance, Compliance, and Principles-Based Securities Regulation}, 45 Am. Bus. L.J. 1, 6-8 (2008); Frederick Schauer, \textit{The Tyranny of Choice and the Rulification of Standards}, 14 J. Contemp. Leg. Iss. 803, 803-04 (2005).
the rule. That is as simple as it can get, and the regulator, or fact-finder, need only find that the speed exceeded the limit and apply the penalty.

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

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

Still, these advantages are tempered by countervailing disadvantages. A rule, because it is certain, does not allow for flexibility or substantive equality. It can be over- or under-inclusive, and can encourage behavior that is socially irresponsible up to the line it draws. In addition, when times change, rules may

109 See, e.g., Kennedy, supra note 106, at 1688 (noting that rules promote “restraint of official arbitrariness and certainty”). See also Schlag, supra note 106 at 384 (describing the argument that the “sharp line” drawn by rules promotes certainty and understandability).
110 See, e.g., Kaplow supra note 106, at 563 (“Because learning about a rule is cheaper, individuals may spend less in learning about the law, and may be better guided by a rule since the law's content can be more readily ascertained.”).
111 See, e.g., Kaplow supra note 106, at 563 (arguing that rules are cheaper to enforce because the majority of costs are borne during promulgation, whereas principles require additional costs for each instance of enforcement).
112 See, e.g., Kaplow supra note 106, at 573 (arguing that rules become cheaper than standards as the frequency of enforcement increases).
113 See, e.g., Schlag supra note 106, at 384-85 (describing how the “sharp line” drawn by rules may mete out seemingly disproportionate punishment).
114 See, e.g., Kennedy supra note 106, at 1695 (noting that with rules, “sometimes perfectly innocent behavior will be punished, and that sometimes plainly guilty behavior will escape sanction”). See also Kaplow supra note 106, at 591 (noting that rules may prohibit socially acceptable behavior while failing to prohibit undesirable behavior).
need to change, but that process may be slow and costly, requiring in the case of administrative regulations, promulgation, debate, and revision.\textsuperscript{115}

In contrast, the speeding principle allows for flexibility.\textsuperscript{116} Here, if the fact-finder determines the weather and lighting were sufficient to allow a speed of 70 miles per hour, then 70 it is. In alternative conditions, the allowed limit might be 50. Drivers face uncertainty, but gain the ability to adapt their behavior to changes in weather, car design, or circumstances. Further, a principle need not be redefined when circumstances change, because the principle incorporates adaptive flexibility upfront.

To be sure, flexibility has its downsides. Neither those trying to abide by the law nor those doing the enforcing are certain what “it” is.\textsuperscript{117} Both have to assess and interpret the principle.\textsuperscript{118} The regulator then has to attempt to enforce its interpretation of the uncertain principle. Those with ample resources have greater incentive to contest the principle’s application to them. The result can be variation, more opportunities for manipulation and risky behavior, as well as increased enforcement costs as regulators struggle to define the inappropriate behavior and then enforce that standard on those who will argue the conduct was not within the intended definition.\textsuperscript{119} As the simple speeding example makes clear, this debate has multiple dimensions. Neither side wins, absolutely. The right choice of a rule-based or principle-based system depends on the circumstances. To the extent that a principle-based standard is more costly for the regulator to enforce and to the extent that the regulator is resource constrained, a principles-based system may result in less enforcement, lower penalties, and a larger \textit{de facto} zone of regulatory immunity for those subject to it.

Although the debate about rules and principles/standards often occurs as if the two never overlap, in reality they usually coexist.\textsuperscript{120} Indeed, the use of the term, “based,” as in “principles-based” or “rules-based” is illuminating. Most

\begin{itemize}
  \item \textsuperscript{115} See, e.g., Kaplow \textit{supra} note 106, at 563 (noting that “rules are more costly to promulgate than standards because rules involve advance determinations of the law’s content”).
  \item \textsuperscript{116} See, e.g., Kaplow \textit{supra} note 106, at 560 (describing how “[a] standard may entail leaving both specification of what conduct is permissible and factual issues for the adjudicator”).
  \item \textsuperscript{117} See, e.g., Schlag \textit{supra} note 106, at 385 (describing how the uncertainty surrounding standards may create “confusion about what is or is not permissible”).
  \item \textsuperscript{118} See, e.g., Schlag \textit{supra} note 106, at 387 (describing how standards require evaluative judgments by subordinates which “increase the likelihood of erroneous determinations”).
  \item \textsuperscript{119} See, e.g., Schlag \textit{supra} note 106, at 385 (describing the argument that with unclear standards, “decision makers in borderline cases are likely to reach erratic results”); see, e.g., Kaplow \textit{supra} note 106, at 562–63 (noting that “standards are more costly for . . . enforcement authorities to apply because they require later determinations of the law’s content”).
  \item \textsuperscript{120} See, e.g., Kennedy \textit{supra} note 106; Kaplow \textit{supra} note 106.
\end{itemize}
systems are really combinations of the two, with the major difference being the
location of the system’s center of gravity in one or the other system.\footnote{121}

The U.S. securities regime has obvious examples of both. Consider the
types of financial disclosures required by Regulation S-K. This telephone book-
length regulation controls the disclosures that companies must make when
seeking to offer securities to the public and when crafting the required annual
reports. Regulation S-K operates by delineating specific required disclosures.
Many of its provisions also contain specific materiality thresholds, or rules.\footnote{122}
But the certainty thereby afforded is undercut by Rule 12b-20 under the Securities
Exchange Act, which obligates an issuer to disclose “in addition to the
information expressly required to be included in a statement or report . . . such
further additional material information, if any, as may be necessary to make the
required statements, in the light of the circumstances under which they were made
not misleading.”\footnote{123} Thus, the SEC’s disclosure instructions backstop a series of
rules with a general principle. Not surprisingly, the SEC likes to wear both a belt
and suspenders.

Now consider Item 404 of Regulation S-K.\footnote{124} It requires disclosure of
transactions exceeding $120,000 between the issuer and directors, officers, 5%
stockholders (as well as the family members of those groups). It also requires
disclosure of related entities in which these groups have an interest greater than
10%, at least when 10% is the materiality threshold for this provision.\footnote{125}
Here, then, is an example of a precise disclosure rule. It is just one of many contained in
the Regulation S-K, which is one of the most lengthy Regulations the SEC has
promulgated.\footnote{126}

A requirement like that contained in Item 404 is clear. Because it is clear,
violations are more straightforward. Either a company discloses all of the required
transactions or it does not. Straightforward violations are easier to prove. If the
violation is easy to spot and prove, enforcing the regulation is also easy.\footnote{127}
Herein lies the rub. Industry might well want a principles-based system because it is more

\footnote{121} See, e.g., Lawrence A. Cunningham, A Prescription to Retire the Rhetoric of
“Principles-Based Systems” in Corporate Law, Securities Regulation, and Accounting, 60 Vand.
\footnote{122} See 17 C.F.R. § 229.402 (2008) (defining the materiality threshold of compensation
information by enumerating a list of material elements of the compensation); 17 C.F.R. § 229.601
(2008) (defining the materiality threshold of contracts that must be filed and disclosed with the
registration statement to the SEC); 17 C.F.R. § 229.903 (2008) (defining, by an enumerated list,
specific activities or events that constitute a “material risk” and should be reported in a disclosure
statement to investors).
\footnote{124} 17 C.F.R. § 229.404 (2008).
\footnote{125} See 17 C.F.R. § 229.404:6(b) (2008).
\footnote{126} See John C. Coffee, Jr., Joel Seligman, & Hillary A. Sale, Federal Securities Laws,
\footnote{127} See Cunningham, supra note 121 at 1424.
difficult to enforce, and will, therefore, result in fewer enforcement actions.128 Rest assured, however, that more is involved in the debate. The next issue is that of safe harbors.129

Contrast Item 404 – a quintessential example of a rule-based system – with the way that industry has pressed for a safe harbor on the definition of materiality. Material misstatements or omissions can, of course, result in liability.130 The definition of the term “material,” thus determines when liability arises. According to the Supreme Court, the key question in this definition is whether a reasonable investor would care. Not all information is equal. Information is material, however, if there is a “substantial likelihood that [a] disclosure . . . would [be] viewed by [a] reasonable investor as having significantly altered the ‘total mix’ of information made available.”131 This judicial definition is a principle. In order to determine whether a misstatement is material, you have to determine who the “reasonable” investor is, what information that investor would find significant, and what information appropriately constitutes the “total mix.” The result is uncertainty about the principle’s reach.

Ironically, despite the vehement calls by industry for a shift to a principles-based securities regime, it has long and inconsistently fought the use of a principle for defining materiality, demanding instead a more specific “rule.”132 The arguments it deploys focus on certainty and consistency.133 The business community wants a sharp-edged safe harbor so that it can make disclosure decisions free of liability concerns.134 In short, the argument for a rule-based approach to materiality is that industry needs to know for certain whether and


129 Safeharbors, or delineated protections, exist throughout the securities laws and regulations. See, e.g., 15 U.S.C. 78u-5(i)(A(B) (providing safeharbor protection for forward-looking statements accompanied by meaningful cautionary language); Rule 10b5-1, Trading “on the Basis of” Material nonpublic Information in Insider Trading Cases, 17 C.F.R. 10b5-1 (defining when certain purchases or sales of securities by an insider are exempt from insider trading liability).

130 See, e.g., 17 C.F.R. § 240.10b-5 (2008) (creating liability for purchasing or selling securities based upon material non-public information); TSC Ind., Inc. v. Northway, 426 U.S. 438, 445 (1976) (court states that liability may be conditioned upon material omissions of facts that a reasonable investor would have found important in deciding whether to invest).


133 See, e.g., Brief for Petitioners at 24, Basic, Inc. v. Levinson, 485 U.S. 224, 236 (1988) (No. 86-279), 1987 WL 881061 (arguing that a rule would have “the benefits of certainty”).

134 See, e.g., Basic supra note 29, at 236 (noting that support for a bright-line rule “seems to be directed solely at the comfort of corporate managers”).
when to disclose. The SEC and the courts have expressed a preference for a materiality principle, long declining to provide any bright-line rule and arguing that to do so would likely encourage risky behavior, right up to any threshold drawn.

If Item 404 provides the classic illustration of a rule, then Rule 10b-5 provides an equally useful archetypal example of a principle-based regulation. Rule 10b-5 supplies the jurisdictional basis for most securities litigation and the vast majority of the damages imposed on corporate issuers. For liability to attach under Rule 10b-5, there must be a material misstatement or omission, made with scienter, on which a person relies in purchasing or selling securities, and which causes the person damages. Scienter is the element receiving the greatest judicial attention. Case law interpreting it abounds. The issue is what level of state of mind speakers must have before they can be held responsible for an alleged material misstatement or omission.

Here again, industry has regularly called for reform and pushed for changes to increase certainty and predictability. In 1995, Congress responded with the Private Securities Litigation Reform Act, which, among other changes, provided for “heightened pleading” of scienter-based claims. The reforms were designed to placate industry. The legislation resulted in significant increases in

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136 See, e.g., Basic supra note 29, at 236 n. 14 (acknowledging the benefits of bright-line rules but dismissing the notion as “unrealistic”); see also In re Columbia Sec. Litig., 747 F. Supp. 237, 243 (S.D.N.Y. 1990) (holding that the Supreme Court has endorsed a fact-specific test for materiality despite some advantages of a bright-line rule).

137 See, e.g., Basic supra note 30, at 236 (“A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress’ policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.”).

138 17 C.F.R. 240.10b-5.


140 See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976). [add citation to Dura Pharmaceutical]

141 See Pritchard & Sale, supra note 139 at 129-130.

142 See Ernst & Ernst at 197.


144 See, e.g., Pritchard & Sale, supra note 139 at 126-127; Hillary A. Sale, Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information...
the dismissal of claims at the pleading stage as well as a continuing battle over how to define scienter. After over a decade of litigation under the 1995 statute, the Supreme Court finally jumped into the fray, again in response to complaints about uncertainty. In 2007, the Court issued its Tellabs opinion that industry praised and touted as clarifying the standard, or making it more rule-like.

But this praise may have been premature as the decision’s actual impact is less clear. Early decisions have produced results that likely have surprised industry. For example, on remand, the Seventh Circuit held in the Tellabs case that the complaint survived the new-improved, more rule-like standard. As a result, the case has now survived the motion to dismiss. Other cases have reached a similar result. A possible message of these decisions may well be that, under pressure, principles mutate into rules. That is, decision-makers try and reduce the uncertainty surrounding a principle, and, as they do so, it becomes easier to enforce – like the speed limit of 70 miles per hour.

What do we learn from these examples? First, it is obvious that straightforward rules tend to be easier to interpret and enforce. In part, the ease of enforcement of rules may well account for the industry’s preference for a principle-based system. Second, we learn that industry does not truly want a principles-based system without substantial qualifications and exemptions. Indeed, in some cases, industry has pushed for standards to migrate to the rule-end of the spectrum. Presumably, any quick shift to a principle-based system would be accompanied by demands for bright-line rules in areas where litigation and enforcement tend to occur, like materiality or 10b-5 fraud claims. Third, then,

Standard on ’33 and ’34 Act Claims, 76 Wash. U. L. Qtly. 537, 552-561 (discussing and citing legislative history and calls for reform).

See Pritchard & Sale, supra note 139; see also Tellabs, Inc. v. Makor Issues & Rights, Ltd. 127 S. Ct. 2499 (2007).

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


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

Id.


See Schauer, supra note 106, at 809–11 (arguing that decision-makers push standards into rule-like form).


On the migration of standards to rules from the perspective of decision-makers, see Schauer, supra note 106, at 809–11.
it appears that industry’s real interest is in a hybrid system. Yet, as we have just seen, the U.S. disclosure regime is just that, a combination of rules and principles. It is not alone. Most other systems, regardless of how they are touted, are also hybrids.155

All this suggests that movement in either direction along the rules/principles continuum is unlikely to provide any quick or easy fix to the U.S. securities regime. Scrapping the entire system in favor of a new-and-improved principles system would create uncertainty, not only because it was principles-based, but also because it would be new. Indeed, a new system might well create at least a short-term litigation boon, as lawyers attempted to “prosecute” cases under the revised principles-based system.

Here, under the system of contingent fee motivated entrepreneurial litigation that the U.S. has long and uniquely accepted, private attorneys can and do obtain very large settlements in the course of enforcing the securities laws and regulations.156 Industry presumably does not want an increase in such actions or settlements, particularly when accompanied by a concomitant increase in uncertainty about new principles. Thus, any discussions about reforms to the U.S. system must include consideration of the environment in which securities disclosure takes place and in which it is enforced. Our system emphasizes ex post adjudication of fraud issues, chiefly through private securities litigation based on Rule 10b-5 and a few other implied private causes of action.157 Although there have been many proposals for reform and virtually everyone supports some reform in principle,158 no specific proposal has yet achieved broad support.

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

155 See Ford supra note 108.
157 Historically, the implied private cause of action arose under Rule 14a-9, which addresses fraud in proxy statements. See, e.g., J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (noting that private securities litigation is a “necessary supplement to Commission action”).
reform requires precisely that sort of attention, with a clearer focus on the U.S. public and private enforcement environments, the role of class actions, and the high level of retail ownership in the United States.  

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

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

**Part IV: The Role of Self-Regulation**

U.S. securities regulation is generally thought to promote a liquid and efficient capital market. Part of its legitimacy comes from its enforcement

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159 See Letter to SEC, supra note 158, at 2.
160 In fairness, the Blueprint does concede this. See Treasury Report, supra note 14 at 21 (“The United States has the strongest and most liquid capital markets in the world. This strength is due in no small part to the U.S. financial services industry regulatory structure, which promotes consumer protection and market stability.”); Letter to SEC, supra note 158, at 1–2.
161 See e.g., John C. Coffee, Jr., Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation, 50 Bus. Law. 447 (1995); see also Treasury Report, supra note 14 at Appendix B (documenting Executive Branch studies of markets and reform proposals over the years).
162 See Coffee, Law and the Market, supra note 53.
163 Id.
164 See Henry M. Paulson, Secretary, Treasury Dep’t, Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets Economic Club of New York (Nov. 20, 2006), available at http://www.ustreas.gov/press/releases/hp174.htm (stating that the U.S. capital markets are the “deepest, most efficient, and most transparent in the world” and that the regulatory structure is “second to none”); Marcel Kahan, Some Problems with Stock Exchange-Based Securities Regulation, 83 VA. L. REV. 1509, 1510-19 (1997) (stating that as compared with other countries, the U.S. capital markets are fairly liquid and trading is cheap); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 136-37 (1993) (comparing the U.S. capital
system. Though many have debated whether U.S. enforcement, and in particular private securities litigation, is excessive, all that can clearly be shown is that enforcement is better funded and more rigorous in the United States than elsewhere, not that it is excessive. Indeed, as Part II of this paper makes clear, the United States has recently weathered a series of corporate frauds that do not suggest that corporate decision-makers have been overdeterred. Any arguments for reform, then, should fully address these issues. The Blueprint does not.

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

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

Still, our mandatory disclosure system has long co-existed with a strong anti-fraud rule. Disclosures must not be misleading, either affirmatively or by half-truth or omission. Most recognize that fraud in the marketplace has significant costs. Policing the market for fraud is thus important in order to markets with those of other countries and showing how much more liquid the U.S. capital markets are.

165 See, e.g., Pritchard & Sale, supra note 139, at 126 (noting “dearth” of empirical work on securities litigation reform); see also Coffee, Law and the Market, supra note 53, at 258-263 (showing greater enforcement “output” in U.S. versus other major market centers); Stavros Gadinis & Howell E. Jackson, Markets as Regulators: A Survey, 80 S. Cal. L. Rev. 1239 (2007) (studying international enforcement regimes).

167 Treasury Report, supra note 14, at 178–79.

169 See, e.g., Donald C. Langevoort, Half-Truths: Protecting Mistaken Inferences by Investors and Others, 52 STAN. L. REV. 87, 117 (1999). (explaining that both courts and SEC regulators require people to “volunteer any … information necessary to make [their statements] not misleading” to avoid being liable in fraud-on-the-market cases).

170 These costs have been thoroughly explored elsewhere and here are discussed only briefly.
promote consumer protection, liquidity and efficiency. In short, punishing fraud allows for “public confidence” in the market. Shareholders and other market monitors can make accurate investment decisions only if disclosures are sufficiently fulsome and truthful. Fraud, of course, interferes with such assessments and, thereby, decreases the accountability of managers. In addition, over time, as markets become unreliable, shareholders will decline to invest or will demand a higher premium because of the market’s tolerance of fraud. When that occurs, liquidity decreases, and the cost of capital likely increases. Of course, excessive deterrence may also reduce market efficiency by leading corporate managers to be overly cautious in their forward-looking statements or even to understate income.

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

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175 See Coffee, Law and the Market, supra note 53(discussing evidence on the relationship between enforcement and the cost of capital).
177 See Plancich et al., National Economic Research Associates Economic Consulting, 2008 Mid-Year Update (2008), available at http://www.nera.com/image/BRO_Recent_Trends_8.5x11_0808.pdf. (revealing that securities class action settlements average between 2% and 3% of investors’ total market losses). See also John C. Coffee, Jr., Reforming the Securities Class Action: An Essay on Deterrence and its Implementation (October 2006) [change citation to 106 Colum. L. Rev. 1534 (2006)] (arguing that class action system can be justified only in terms of deterrence); Donald C. Langevoort, Capping Damages for Open-Market Securities Fraud, 38 Ariz. L. Rev. 639, 646-47 (arguing that compensation is not a necessary part of the securities package); Pritchard, supra note 172 at 946-47.
“implied private rights of action” are for the courts to determine. 178 Further, although much recent academic commentary has stressed the likely superiority of public enforcement over private enforcement, 179 the Blueprint takes precisely the opposite approach, attacking, first, state and, then, federal enforcement, and proposing to minimize both through delegation to the SROs.

The Blueprint’s assault on state enforcement is straightforward: It should be preempted. 180 This suggestion is not new. 181 Industry has repeatedly urged preemption of state securities law and enforcement. 182 In fact, in 1997, NSMIA did preempt much of the states’ securities regulatory apparatus for securities traded in national markets, but it left state anti-fraud enforcement largely intact. 183

In contrast, the Blueprint focuses not on state regulation in the sense of rule-making and oversight, but on state enforcement of antifraud rules. Increasingly, state Attorneys General have played an aggressive role in prosecuting securities fraud and have pushed the SEC to be more vigorous in its own enforcement efforts. 184 The Blueprint’s proposal, however, would preclude the New York Attorney General’s office from playing the central role that it recently has. In support of such preemption, the Blueprint notes that the “current multi-agency business conduct oversight structure creates uneven enforcement, potential enforcement gaps, disputes over jurisdiction, and regulatory inconsistency.” 185 All that may be to some degree true, but such “multi-agency oversight” also produces competition, which in turn leads to more aggressive enforcement and fills gaps. Recent experience suggests that this is a form of regulatory competition that actually appears to have worked. If one believes securities fraud tends to be underenforced, competition is desirable and creates a

178 Treasury Report, supra note 14, at 119. Interestingly, at several other points the Treasury Reports states that implied rights of action should be harmonized across securities. See, e.g., Treasury Report, supra note 14, at 18. At least with respect to the implied right of action for 10b-5 claims, the Supreme Court has spoken. See Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, 128 S. Ct. 761, 773 (2008) (stating that with the PSLRA Congress “ratified the implied right of action” and “accepted [the] private cause of action”).


183 Treasury Report, supra note 14, at 179-80. [add discussion of non-preemption of state anti-fraud enforcement].

184 John C. Coffee, Joel Seligman, and Hillary A. Sale, Securities Regulation 1277 (10th ed. 2007) (discussing role of Eliot Spitzer in Enron investigations and prosecutions).

185 Treasury Report, supra note 14, at 172.
failsafe check and balance against the prospect of regulatory capture. Even if one believes the reverse, automatic preemption does not logically follow.186

Part II has already noted that then Attorney General Eliot Spitzer was ahead of the SEC in the investigation of securities analyst conflicts and “market timing” in mutual funds. The same can be said for the Enron investigation, where he used New York’s unusually flexible securities law to investigate the role of the investment banks in the Enron fraud.187 By all accounts, he was once again “out in front of” the SEC and his investigations created pressure on the SEC to enter the battle and insist on a settlement by the banks.188 Indeed, at the time of Spitzer’s investigation, it was unclear whether the SEC intended to pursue the banks at all, let alone aggressively.189

This phenomenon of the New York Attorney General stealing a march on the SEC is not limited to the brief reign of Eliot Spitzer. More recently, his successor, Andrew Cuomo, has been the most aggressive enforcer in the recent auction rate securities cases, negotiating settlements with the major investment banks totaling well over $50 billion.190 Earlier, Attorney General Cuomo reached the first settlements with the credit rating agencies.191 Other Attorneys General have also played a significant role, along with the SEC, in resolving similar these cases.192

Not only have the State Attorneys General frequently been first, they have often been tougher. A recent study of the restitution involved in mutual fund cases is particularly revealing.193 It compares restitution in cases involving both the New York Attorney General’s office and the SEC, with those involving the SEC

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186 See supra notes 181-182 and accompanying text.
187 Coffee, Seligman, & Sale, supra note 184, at 1277.
190 Cuomo Seeks Settlement With 3 More Banks, N.Y. Times, August 11, 2008 (itemizing various settlements with Citigroup, UBS, Morgan Stanley, and Bank of America where the banks have either made or agreed to make settlements totaling $47.5 billion).
191 Jenny Anderson & Vikas Bajaj, Rating Firms Seem Near Legal Deal On Reforms, N.Y. TIMES, June 4, 2008, at C1 (listing various changes that Cuomo was negotiating with the credit rating agencies in order to improve the transparency of the ratings process); Reuters, Rating Agencies Reach Settlement Over Fees, N.Y. Times, June 6, 2008, available at http://www.nytimes.com (discussing the deal that was reached with the credit rating agencies and the reforms that the agencies have agreed to implement).
The study concluded that the cases with both “prosecutors” yielded considerably higher restitution ratios. The study controlled for a variety of factors to reach the conclusion that the higher restitution in the cases with the New York Attorney General appear to be attributable to its relative aggressiveness. Further, the study concludes that the “aggressiveness explanation” is consistent with the career concerns of the regulator as well as with regulatory capture theories.

Under the system proposed by the Blueprint, the most that a State Attorney General could do, if so inclined, would be to “suggest” an investigation, or at least raise the question of one, with the various federal regulators and self-regulatory bodies. It could proceed further, however, only with their approval.

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

This does not mean that regulatory competition between state and federal enforcers never produces problems or inconsistencies. But when it does, the more politically accountable approach would be to force the SEC to take public action

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194 See Zitzewitz, supra 193, at 4 (noting that settlements not involving the New York Attorney General’s office had the lowest restitution ratios among those in sample).
195 See Zitzewitz, supra 193, at 4 (settlements involving New York had ratios of .78, while those with the SEC alone, had ratios of .07).
196 See Zitzewitz, supra 193, at 4–6.
197 See Zitzewitz, supra 193, at 4–6.
198 Treasury Report supra note 14, at 180:
For example, given the experience of state officials with state-chartered financial institutions or other locally based knowledge of business conduct issues (e.g., complaints regarding certain business practices in local areas), state officials could bring these issues to CBRA’s attention. Based upon that local information, state officials could be given the authority to proceed with full investigations and enforcement actions if approved by CBRA. An alternative to this grant of authority to state officials should be for CBRA (or the appropriate SRO) to use such information to further investigate compliance issues and take enforcement actions as necessary. In both cases, the goal should be to build off the local knowledge of state officials and to provide an appropriate role for states in business conduct oversight.
199 Zitzewitz, supra note 193, at 4–5 (noting that when New York gets involved in prosecuting a case, the restitution-to-harm ratio increases significantly and implies that New York pursues such prosecution more aggressively).
200 Zitzewitz, supra note 193, at 30.
to preempt the state regulator. This both has political costs for the SEC (as it should have) and adds transparency to the process. To simply assume that the SEC would always resist state enforcement and desire its preemption seems an extraordinarily arbitrary presumption. Thus, we will suggest an alternative mechanism for resolving actual conflicts between state and federal enforcers in the concluding section of this article.

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

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


\[202\] See supra notes 34 to 40 and accompanying text.
with CRBA, while relying on an SRO model for compliance and enforcement.\footnote{Treasury Report, supra note 14, at 178–179.}

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

Other than workload and a vague claim about the need to achieve convergence,\footnote{Treasury Report, supra note 14, at 179.} the Blueprint is devoid of a rationale for why the SROs should absorb enforcement or, more importantly, why they would be good at it. Given that fraud, or more properly, the lack thereof, is so important to the marketplace, the question is a serious one.\footnote{See U.S. v. O’Hagan, 521 U.S. 642, 658 (1997) (describing honest markets as “animating purpose” of Securities Exchange Act).; See supra Part III.} As Part III has emphasized, the recent experience of the U.S. with an unparalleled level of fraud only adds to the importance of making the right enforcement decision – and for the right reasons.\footnote{See supra Part III.}

The Blueprint’s silence on this question does not imply that serious arguments could not be made in favor of greater reliance on SROs.\footnote{These have been explored at length in various articles, many of which were published in the University of Virginia Law Review. See, e.g., Adam C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers, 85 Va. L. Rev. 925 (1999) (exploring role of exchanges as regulators); See, e.g., Paul G. Mahoney, The Exchange As Regulator, 83 Va. L. Rev. 1453, 1475-1500 (1997) (explores three assumptions underlying the argument that government regulation is necessary over the financial markets and concludes that a return to self regulation would improve U.S. competition while not unduly harming investors); Marcel Kahan, Some Problems with Stock Exchange-Based Securities Regulation, 83 Va. L. Rev. 1509, 1510-19 (1997) (analyzes potential problems with self regulating exchanges and concludes that though Mahoney’s argument for a deregulated securities market may be ideal for countries just beginning securities regulation, it should not be adopted wholesale in the United States where the current system is stable and performing relatively well).} To consider these, let’s begin with an initial question: who are the SROs? The Blueprint defines them to include the exchanges and the self-regulatory bodies for brokers and dealers (now FINRA). Today, each exchange or market has its own set of rules and regulations with which listed companies must comply.\footnote{See, e.g., NYSE Euronext Listed Company Manual, available at http://www.nyse.com/frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1182508124422.html&displayPage=lcm/lcm_section.html; NASDAQ Manual Online, http://nasdaq.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=1479.} In 2007, the NASD was consolidated with the listed company regulation, enforcement, and arbitration functions of the New York Stock Exchange, resulting in FINRA. According to FINRA’s website,

FINRA touches virtually every aspect of the securities business—from registering and educating industry participants to examining securities
firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors and registered firms. It also performs market regulation under contract for The NASDAQ Stock Market, the American Stock Exchange, the International Securities Exchange and the Chicago Climate Exchange.209

Thus, it is fair to say that the key SROs are the exchanges, and FINRA, and arguably the PCAOB, which serves as the SRO for auditing firms.210

Next, the more difficult and critical issue involves whether the SROs can be effective enforcers against their own listed companies.211 The SRO listed company rules are not particularly textured. Instead, they tend to be of a check-the-box nature – i.e., classic “rules” with no hint of principles lurking beneath the surface. For example, although both NASDAQ and NYSE/Euronext require some committees of listed companies’ boards to be composed solely of independent directors, the definitions of independence are based on narrow and highly specific financial criteria.212 More fulsome disclosure might be warranted, but the listing rules do not require it.

More importantly, exchanges are businesses. In theory, they have an interest in creating rules and listing standards to attract investors.213 Attracting investors attracts listed companies.214 As economic actors, then, exchanges should understand that market integrity is important “in attracting business.”215 Companies want to list on efficient markets where they are likely to attract investors.216 Again, in theory, these basic interests could, over time, lead the SROs to develop rules and regulations to prevent fictitious transactions and securities, as well as fraud and other types of market manipulation. Hopefully, the SROs would want to promulgate regulations that promote their own reputations and, thereby, garner business. The fact that today there are two highly

209 http://www.finra.org/AboutFINRA/index.htm
210 See supra notes 184-185 (discussing expanded role of state Attorneys General); see also Free Enterprise Fund v. Public Co. Accounting Oversight Bd., 537 F.3d 667, 669 (2008) (upholding the constitutionality of the PCAOB against an attack that it violated the Appointments Clause of the Constitution).
211 Indeed, the discussion in the text at notes 90-91 and 101-102, supra points out that self-regulation involving the investment banks and the CSE provisions was a failure.
212 See Bainbridge
213 See Paul Mahoney, The Exchange as Regulator, 83 Va. L. Rev. 1453, 1454-55, 58 (1997. There is some historical support for this proposition. Exchanges were involved in regulating their listed companies in 1933 and 1934 and the regulations then did not differ significantly from those adopted with the 1933 and 1934 Acts. See Mahoney at 1459-62, 1465-69.
215 Pritchard, supra note 172, at 963.
216 See Pritchard, supra note 172 at 963 (noting that exchanges provide liquidity to listed companies).
competitive U.S. exchanges enhances this argument – competition should encourage the development of efficient regulations.\textsuperscript{217}

Arguably, the exchanges might also have some advantages in rulemaking. They are close to the market and have informational advantages that the government does not have.\textsuperscript{218} They would certainly have the opportunity to develop regulations based on the information to which they have access and, in particular, with respect to how the markets work. Perhaps relying on this view of SRO’s advantages, the Blueprint urges that all SRO proposed rules be self-certifying, rather than subject to the check and, arguably, balance, of government approval.\textsuperscript{219}

These are fairly straightforward economic arguments that have been made many times before. But there are complications. For example, the arguments for why exchanges and SROs make superior regulators sound much like the arguments that used to be made for why gatekeepers never fail. Indeed, over time, the more sophisticated proponents of SRO regulation have come to place less emphasis on the investor protection side of the SROs’ regulatory function and more on their need to attract listings.\textsuperscript{220} Further, today, even strong advocates of eliminating some aspects of SEC rulemaking functions and private class actions continue to stress public enforcement provisions.\textsuperscript{221}

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

In addition, the economic arguments in favor of having the SROs take on these responsibilities rely significantly on reputation and market forces. Yet, these factors may be generally less effective than assumed. As Marcel Kahan has argued, exchanges have limited incentives to expose “bad” information about

\begin{itemize}
  \item \textsuperscript{217} In today’s world, although the exchanges and markets have their own listing standards, FINRA now occupies the enforcement field for both NASDAQ and NYSE/Euronext. Thus, the competition argument is debatable for enforcement purposes. See Pritchard, supra note 172, at \_.
  \item \textsuperscript{218} See Paul Mahoney, The Exchange as Regulator, supra note 179, at 1498 (stating that the benefits of allowing the exchanges do the rulemaking outweigh the drawbacks because of the exchanges superior knowledge about investors).
  \item \textsuperscript{219} Blueprint, supra note 14, at 116.
  \item \textsuperscript{221} See Pritchard, supra note at 172; Mahoney, supra note 218.
\end{itemize}
their listed companies.222 Information that casts the exchange in a negative light will harm its ability to attract investors and other companies.223 If they have little interest in disclosing their own problems, they will presumably have little incentive to ferret information out in the first place.224 Thus, the reputational and market forces cut both ways here – particularly with respect to enforcement.

Exchange-based enforcement may not be effective for other reasons as well. Listing is voluntary. Listed companies who are dissatisfied have choices (indeed that is part of the rationale for the Blueprint’s recommendations). An obvious choice is to select a different exchange and with it a different regulatory body, including a non-U.S. exchange and a non-U.S. regulator. This fear of the foreign migration of listed companies may well create an incentive for the exchanges, which are public companies themselves, from enforcing their regulations aggressively. Yet, the social loss from “soft” regulation may exceed the gains from attracting more listings. Investors may lose precisely as the investment banks gain.225

In addition, because the SEC regulates many aspects of securities law, not just those concerning the listed companies themselves, delegation to SROs implicates the interests of third parties. To begin with an obvious fact, the SEC has the power to regulate and sanction acts beyond those of listed companies and members.226 For example, in 2007, the SEC preempted the exchanges from adopting an “uptick” rule to regulate short selling, and in 2008 the SEC has proposed regulations on “naked short selling.” Such regulations focus on traders who are not necessarily exchange members (e.g., institutional investors, hedge funds, etc.). Today, the exchanges no longer have effective power to control these aspects of securities regulation. It seems a fair question to ask whether it would be desirable to delegate power over these third parties to a public company that is being regulated by itself. Arguably it could have an incentive to prevent any sort of short-selling or speculative trading at all. The very concept of delegating such a dramatic level of responsibility to a public company with a board focused on its

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222 Marcel Kahan, Some Problems with Stock Exchange-Based Securities Regulation, 83 Va. L. Rev. 1509, 1518 (1997) (arguing that stock exchanges have an interest in portraying a favorable image to the investing public and therefore have little incentive to search for and disclose violations of companies listed on their exchanges).
223 Id.
224 Id.
225 From the standpoint of market professionals, “soft” regulation that makes limited use of enforcement may imply more transactions, more listings and offerings, and a higher volume of business – all maximizing the revenues of market professionals. Similarly, foreign issuers may prefer and migrate to a soft regulatory system, even if it implies a higher cost of capital, because it permits their controlling shareholders to retain greater private benefits of control. Domestic investors, however, can expect that weak regulation and a disinclination to utilize enforcement sanctions implies both that greater private benefits will be extracted and that firms in this market will have a higher cost of capital. See Coffee, Law and the Market, supra note 53, at 237 and 311.
226 See Mahoney, supra note 218, at 1498.
自己的利润，提出了关于外包的质疑，这些问题需要非常严肃地讨论。《蓝图》在这方面完全忽视了这些问题。

最后，今天，交易所将他们的执法重点从公众公司转移到经纪人身上。因此，FINRA，作为纽约证券交易所和纳斯达克的联合执法机构，并不是一个“全面的”执法人。相反，它倾向于占据经纪商/经销商领域，把其他问题留给SEC。因此，SEC和FINRA已经达成了一个有效的分工，允许专业化。将责任转移到自律组织会破坏这种分工，把行业放在自己身上。

总之，没有任何其他的合理理由，CBRA的工作量，蓝图建议广泛地消除SEC和州的执法权力，让被监管者自己执法。然而，交易所目前依靠政府的援助和政府的权力来打击欺诈。毫无疑问，交易所希望SEC更认真地听取他们的观点，可能SEC应该被推动加快对SRO规则的审查（这一直是SRO和SEC之间长期的紧张关系，但SEC已经承诺会加快）。但仅靠法规并不能构成一个充分的反欺诈制度。威慑需要检测，检测需要侦探，而侦探需要动机来实现结果。现有的制度是一个三重执法制度——交易所做一些，SEC做一些，而州提供了宝贵的备份。228这些备份是关键，因为它们提供了一种防止监管俘获的保险机制。尽管交易所可能在某些方面能够发挥作用，但严重的欺诈需要一个外来的介入。229蓝图，然而，会用自律来替代外来的介入。

**Part V: Consolidation and Coordination**

虽然我们到目前为止对蓝图持批评态度，对它的非支持的对自我监管的信任和自然原则优于规则的观点，蓝图的这两个方面的贡献是微不足道的。它的核心贡献是呼吁对金融监管体系进行强制性整合，该体系已经变得过于分散。此外，蓝图也做出了一个精明的判断，即采用“双峰”或多个机构的监管结构，将消费者保护、商业行为和披露监管置于一个监管机构之下，而传统的审慎性金融监管（即“安全和稳健”监管）则置于另一个监管机构之下。230

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227 See also Mahoney, supra note 218, at 1499; Pritchard, supra note 172 at 976–77.
228 See Pritchard, supra note 172, at 976–77.
229 See Pritchard, supra note 172, at 976–77.
230 The Blueprint actually proposes a tripartite model with a “market stability” regulator, a “prudential financial” regulator, and a “business conduct” regulator. See Blueprint at 13–14. Effectively, once one translates these terms into the current organizational environment, this means that the Federal Reserve would not be consolidated with the Office of the Controller of the...
effect, the Treasury Department has followed Australia, rather than the U.K. – and wisely so. One unified regulator, which is the U.K. model, places too many responsibilities under one regulator, thereby masking the conflicts that can arise between consumer protection and maintenance of bank solvency and soundness.

But if what one accepts the superiority of the “twin peaks” model, that still leaves open the question of how regulatory authority should be allocated between the two agencies. Specifically, assume that the Blueprint is influential and, acting upon it, some future Administration resolves to pursue a “twin peaks” model that assigns the SEC authority over disclosure, business conduct and consumer protection, but gives some amalgam of the OCC and the Federal Reserve authority over the safety and soundness of financial institutions. What responsibilities might still migrate from one agency to the other? In Part A below, we recommend that “prudential” regulatory authority over all financial institutions be consolidated in the Federal Reserve/OCC successor. As the agency which ultimately must fund bailouts for troubled financial institutions, it has the best incentives to protect bank safety and soundness. As a practical matter, this means that the SEC would largely surrender its authority to administer its “net capital rule” and would instead look to the Federal Reserve to restrict excessive leverage at investment banks, mutual funds, and hedge funds.

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

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

The SEC has administered its net capital rules from the agency’s outset.231 Why should it abandon this authority to banking regulators? Our answer is two fold: (1) times have changed, and (2) banking regulators have the comparative advantage because they focus on precisely these issues of risk and leverage over a broad range of financial institutions.

Times have changed in several critical respects: First, as earlier discussed, the major investment banks have either failed, merged with commercial banks, or reconstituted themselves as bank holding companies. Today, most large broker

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231 Federal net capital standards for broker dealers have been administered by the SEC since its inception in 1934, and the precursor of the current net capital rules, which are predicated on Section 15(c)(3) of the Securities Exchange Act of 1934, dates back to 1938. See L. Loss and J. Seligman, SECURITIES REGULATION (3rd ed. 1991) at 3128-3133. Rule 15c3-1 dates from 1975.
dealers are part of a larger financial conglomerate, and their risk management activities, capital adequacy, and operational status can be meaningfully understood only on a consolidated, entity-wide basis. Indeed, the SEC recognized this fact in 2004 when it put into place its “consolidated supervised entity” (CSE) framework, which allowed broker-dealers and their holding companies to voluntarily elect to be subject to SEC supervision with respect to capital adequacy on a group-wide basis. The SEC recently abandoned the CSE program, conceding its failure, and others have viewed it as an instance of regulatory capture.

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

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

But if the growth of derivatives is the key weakness, the SEC is poorly positioned to address or resolve this problem. Under Section 3A of the Securities Exchange Act, the SEC is broadly denied authority over swap agreements in sweeping language that even denies the SEC the ability to “recommend” or “suggest” registration of derivatives or to impose “reporting or recordkeeping requirements.” While the SEC has hesitated and even resisted greater regulation of swaps, the Federal Reserve has consistently sought the

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establishment of an industry-wide clearing house for the trading of over-the-counter derivatives.\textsuperscript{238}

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

Fourth, it is open to question whether capital adequacy regulation would ever become a major priority for the SEC. By culture and philosophy, the SEC is a disclosure regulator, whose concerns with risk and leverage are generally satisfied once full disclosure is made.

For the future, it seems obvious that financial regulators will need to restrict leverage and risky trading practices at investment banks and other large financial institutions. The agency best suited to accomplish this task is not the SEC. Banking regulators have better skilled personnel (and more of them), better information (acquired from their regulatory oversight of commercial banks and other financial institutions), and greater power over their regulated institutions. This does not mean that the SEC should be stripped of all power in this regard,\textsuperscript{239} and certainly the SEC should be consulted by the prudential regulator. But the primary responsibility for determining capital adequacy should be given to the prudential regulator, as the body with the greater experience and superior resources.

\textbf{B. State/Federal Relationships in a Competitive Environment}

We have earlier argued that competition among enforcers is healthy and has filled gaps in securities enforcement. But limits may need to be placed on this competition. Consider a circumstance that briefly arose during New York


\textsuperscript{239} Today, there are an estimated 8,000 broker-dealer firms registered with the SEC. Of these, we doubt that there are no more than a very small number whose financial failure could threaten serious damage to the financial system. Thus, we are not suggesting that the SEC be stripped of authority to supervise these smaller firms (or even that the Federal Reserve would be a good regulator for these smaller firms). Our focus is instead on those financial institutions (whatever the legal category they fall into) that are either too big or, more typically, too entangled to fail.
Attorney General Spitzer’s settlement negotiations with Merrill Lynch and other investment banks over conflicts of interest surrounding securities analysts. For a time, Mr. Spitzer was convinced that the only appropriate remedy was a prophylactic rule under which investment banks that underwrote securities would be barred from employing securities analysts. The investment banks would therefore be required to spin off or sell their research divisions to firms that did not underwrite securities. Although the New York Attorney General was basically armed only with an antifraud statute, that statute was liberally phrased and carried criminal penalties. The pressure of high potential liability can coerce a defendant to agree to virtually any non-pecuniary terms that reduced its financial or criminal liability. Here, the financial industry’s fears are not without some basis in fact.

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

240 See Coffee, Seligman, & Sale, supra note 184 at 1277–78 discussing broad reach of Martin Act and Spitzer’s use of it. See also Mike McIntire, Two Views of a Rising Star: Populist Warrior or Reckless Foe of Big Business, N.Y. Times, Oct. 15, 2006, at Metropolitan Desk 35 (describing how Eliot Spitzer used the Martin Act to force large Wall Street firms such as Merrill Lynch to disclose conflicts of interest).

241 Of course, there would have to be a time limit on the application of any such power to veto or abrogate state rules and settlements. For example, it might extend for ninety days after the SEC receives formal notice from the state regulator of its action, which would incentivize the state regulator to provide early notice to the SEC and possibly to engage in pre-settlement discussions with it. Where a settlement’s provisions were upset, both sides would have the right to renegotiate, and the settlement would not remain in force, minus the provision that was deleted. The concept of such a federal power over state regulators is not fundamentally different from the power that the SEC today has over the SROs to amend, repeal or abrogate their rules. See Section 19(c) of the Securities Exchange Act of 1934, 15 U.S.C. §78s(d) (granting SEC authority to “abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization . . . or otherwise in furtherance of the purposes of this title . . . ”). We do not address the standard for judicial review of the SEC’s decisions in this regard. But see Business Roundtable, Inc. v. SEC, 905 F.2d 406 (D.C. Cir. 1990).
for deeming the action contrary to the public interest or the protection of investors.

The logic of this proposal is that the SEC is politically accountable and should remain so. Were the SEC to take action invalidating a rule or settlement reached by state regulators, it would be subject to political attack and criticism – and properly so. State attorneys general are adept, possibly more adept than the SEC, at mobilizing public opinion, and the press would predictably focus on the case. As a result, Congressional oversight of the SEC’s actions would be highly likely.

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

CONCLUSION

What should we learn from this crisis?

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

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

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

Fourth, simple rules typically work better than complex ones. Although a prophylactic rule that places a ceiling on leverage (as the SEC’s standard net capital rule did) has its costs, it is capable of effective implementation, while a more optimal rule (in terms of its theoretical design) may be beyond the effective capacity of many bureaucracies to implement.

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242 This is, of course, a paraphrase of Mr. Prince’s quotation. See text and note supra at note 93.
Against this backdrop, we believe that the Blueprint’s proposal to confine the U.S. securities regulator to the promulgation of broad principles and leave it to the SROs to issue specific rules implementing those principles, while also preempting state enforcers, is precisely the wrong prescription. At most, we propose the SEC be given a more limited ex post power to restrain state regulators, but not to preempt them.

All this said, the Blueprint still makes an important contribution in calling for the consolidation of financial regulators and by favoring the “twin peaks” model of separating the consumer protection regulator from the “prudential” or “safety and soundness” regulator. To limit excessive leverage and risky trading practices, one must give a greater role to the prudential regulator. Precisely because “prudential” regulation of leverage and risk requires the regulator to go beyond disclosure and reach paternalistic judgments about what level of risk is unsound, we doubt that the SEC is ideally suited to play this role. Neither its culture nor its expertise incline it to go beyond its normal mandate of ensuring full disclosure. It contrast, banking regulators can consider all major financial institutions, including investment banks, from a common perspective and apply a common standard. At such a task, we believe the Federal Reserve or similar agency has the comparative advantage, is less exposed to capture, and can outperform the SEC.

Important as the issues we have discussed are, we must close with the nagging sense that they will still be the subject of debate when the Virginia Law Review in due course convenes its “100th Anniversary of the SEC Symposium.” Law reform is a marathon, not a sprint.