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Recommended Citation
Fisch, Jill E., "Top Cop or Regulatory Flop? The SEC at 75" (2009). *Faculty Scholarship*. Paper 265.
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TOP COP OR REGULATORY FLOP? THE SEC AT 75

Jill E. Fisch[*]

I. INTRODUCTION

JOHN Coffee and Hillary Sale's article, *Redesigning the SEC: Does the Treasury Have a Better Idea?*,[1] was written for a symposium celebrating the seventy-fifth birthday of the Securities and Exchange Commission. The celebration came at a most inopportune time. The market developments of October 2008—developments that took place contemporaneous with the live presentations at the conference—reflected the most severe capital market decline since the Great Depression. Over the course of a few weeks, several of the country's largest financial institutions suffered critical or near-critical crises, requiring the injection of unprecedented bailout funds. In a single week in October, 2008, the Dow Jones Industrial Average fell by more than 20%.[2] In a one-year period, the Dow Jones Wilshire 5000, reflecting most U.S. publicly traded stocks, lost $8.4 trillion in value.[3]

More significantly, although the SEC has long been "the crown jewel of the financial regulatory infrastructure,"[4] recent developments have called that characterization into question. The SEC has been the target of relentless criticism ranging from claims that it mishandled derivatives regulation, oversight of securities firms, and market risk, to assertions of delays and blunders and possible in-

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1 95 Va. L. Rev. 707 (2009).

2 E.S. Browning & Annelena Lobb, Market's 7-Day Rout Leaves U.S. Reeling: Stocks in a Slow-Motion Crash as Dow Drops Another 679 Points; After Year of Declines, Investors Lose $8.4 Trillion of Wealth, Wall St. J., Oct. 10, 2008, at A1.

3 Id.

4 Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis: Before the S. Comm. on Banking, Housing, & Urban Affairs, 110th Cong. 7 (2008) (testimony of Arthur Levitt, Jr., Senior Advisor, The Carlyle Group), available at http://banking.senate.gov/public/_files/LEVITTBankingCommitteeTestimonyFINAL101608.pdf.

dustry capture at the Division of Enforcement.[5] These criticisms followed the Treasury Department's Blueprint of Financial Regulation—released in March 2008—that criticized the SEC's approach to regulation as obsolete and proposed a plan of regulatory consolidation that would effectively lead to the agency's demise.[6] Most recently, the revelation that the SEC failed to discover a $50 billion Ponzi scheme at Madoff Investment Securities, despite having received allegations of wrongdoing for over a decade, suggests fundamental weaknesses in its core enforcement operations.[7] Given the serious questions as to whether the agency will live to see eighty, it cannot be blamed for "crying" at this party.[8]

Coffee and Sale's article focuses largely on the Blueprint. The authors concur with the Treasury Department's observations that the existing regulatory structure is out of date, as well as its prescription for regulatory consolidation.[9] In particular, Coffee and Sale identify a number of key developments in the past twenty years that have placed new pressure on regulators. These developments include the growth of behavioral economics and a corresponding loss of faith in the efficient capital market hypothesis, a series of corporate governance and other financial scandals, and a trend toward deregulation of the financial markets fueled by privatization and globalization.[10]

A regulatory structure that has failed to keep pace with financial market developments increases this pressure. The historical divides

[5] See generally Sec. & Exch. Comm'n, Office of Inspector Gen., Report of Investigation: Case No. OIG-431; Re-Investigation of Claims by Gary Aguirre of Preferential Treatment and Improper Termination 187 (2008) [hereinafter Aguirre Report] (finding that SEC officials "conducted themselves in a manner that raised serious questions about the impartiality and fairness" of an insider-trading investigation), available at http://finance.senate.gov/press/Gpress/2008/prg100708.pdf.

[6] Dep't of Treasury, Blueprint for a Modernized Financial Regulatory Structure 11–13 (2008) [hereinafter Blueprint].

[7] See, e.g., Associated Press, Congress Plans to Investigate Madoff Scheme; Mukasey Recuses Himself From Justice Probe, Law.com, Dec. 18, 2008, http://www.law.com/jsp/article.jsp?id=1202426854578 [hereinafter Congress Plans] (quoting Chairman Cox as stating that "[c]redible and specific allegations regarding Madoff's financial wrongdoing going back to at least 1999 were repeatedly brought to the attention of SEC staff").

[8] Lesley Gore, It's My Party *on* The Best of Lesley Gore: The Millennium Collection (Mercury Records 2000).

[9] Coffee & Sale, supra note 1, at 774.

[10] Id. at 710–14.

that produced our existing regulatory structure—the divide between banks and securities firms, between securities and commodities, and between broker-dealers and investment advisors—have eroded, leading to a system in which similar functions are under the regulatory oversight of different agencies. In some cases this system produces jurisdictional conflicts; in others, it may lead to regulatory gaps. The growth of new financial products that do not easily fit within the regulatory framework and risk analysis applicable to traditional securities, commodities, and insurance policies expands these gaps. Thus, critics may reasonably question whether the SEC and the regulatory structure as a whole have kept pace with market developments.

Going forward, the capital markets crisis has added urgency to the forces that motivated the Treasury Department's Blueprint. Market crises invariably lead to regulatory reform. Indeed, the SEC owes its existence to the stock market crash of 1929 and the subsequent Great Depression.[11] The comparatively less severe market reaction to the revelations of corporate misconduct at Enron, WorldCom, and various other companies led to the adoption of the Sarbanes-Oxley Act of 2002.[12] The recent crisis is no exception. The crisis has already generated unprecedented government actions including extensive efforts to bail out private financial institutions. It is likely to produce major structural reforms as well.[13] Coupled with the reform effort are a series of recent revelations of seemingly blatant regulatory failures. In light of these developments, what role, if any, remains for the SEC?

Coffee and Sale offer a starting point. First, they look globally for alternatives to the U.S. system, considering the structure of fi-

[11] The Securities Exchange Act of 1934, the statute that established the SEC, explains the necessity for regulation as follows:

> National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets . . . .

Securities Exchange Act of 1934 § 2(4), 15 U.S.C. § 78b(4) (2006).

[12] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C. and 18 U.S.C.).

[13] David M. Herszenhorn, Bush Signs Bill, N.Y. Times, Oct. 4, 2008, at A1 (reporting that Congress approved and President Bush signed a $700 billion economic bailout package).

nancial regulation in other major capital markets and the forces behind that structure.[14] Second, they analyze the Commission's responsibility for the 2008 financial crisis, focusing in particular on the Consolidated Supervised Entity Program and its effect on the leverage and risk management policies of the major investment banks.[15] Finally, they consider three of the Blueprint's specific proposals for reform: 1) a switch from rules-based to principles-based regulation; 2) preemption of state securities enforcement; and 3) increased reliance on industry-based regulation, particularly delegation to self-regulatory organizations.[16] Although Coffee and Sale largely reject the Blueprint's proposals, they ultimately concur with the Blueprint's prescription of regulatory consolidation and argue that, in particular, banking regulators (and not the SEC) should engage in prudential regulation of both financial institutions and the markets.[17]

Coffee and Sale offer compelling reasons to rethink the SEC's role as prudential regulator for financial institutions. Their analysis, however, both of the SEC's responsibility for the current crisis and of its potential future role, is incomplete. If the fiscal crisis of 2008 has taught us anything, it is that the SEC's traditional objectives of investor protection and disclosure transparency are critically important in maintaining the health of capital markets and reining in the animal spirits that contribute to bubbles and fraud. Developments dating back to before Coffee and Sale's article as well as more recent revelations demonstrate that the SEC's failures have extended into its core competencies of enforcement, financial transparency, and investor protection.

Critically, this article will argue that the failures in financial regulation cannot be passed off as the result of a "balkanized system."[18] If the SEC has failed, it is not because of regulatory gaps, global competition, or the convergence of financial service providers, but a lack of functional effectiveness. By the same token, re-

[14] Coffee & Sale, supra note 1, at 717–25.
[15] Id. at 735–44.
[16] Id. at 744–64.
[17] Id. at 764–67.
[18] Henry M. Paulson, Jr., Sec'y, Dep't of Treasury, Remarks on Blueprint for Regulatory Reform (Mar. 31, 2008) (transcript available at http://www.treas.gov/press/releases/hp897.htm).

form does not depend on a massive overhaul of financial regulatory structure. The SEC's survival requires a renewed emphasis on leadership, increased independence, and enhanced oversight and analysis of market developments.

I. THE COFFEE AND SALE ASSESSMENT OF THE BLUEPRINT

A. Regulatory Consolidations—Lessons from Abroad

Although they concur generally with the Blueprint's prescription for structural reform and regulatory consolidation, Coffee and Sale convincingly attack many of the Blueprint's specific claims and proposals. First, and most important, they challenge Treasury's xenophilia. The Blueprint touts the regulatory approaches adopted by the United Kingdom, Australia, and the Netherlands and argues that the success of these approaches "reinforce[s] the importance of revisiting the U.S. regulatory structure."[19] Coffee and Sale examine the historical background of non-U.S. reforms more closely and conclude that the Blueprint's history "involves an element of historical fiction."[20] Importantly, they highlight the irony of the Blueprint's endorsement of the U.K. system. The United Kingdom's 2000 reforms were adopted in specific response to the failures of self-regulation. Yet, although it touts the U.K. approach, the Blueprint subsequently argues for increased reliance on self-regulation rather than government oversight.[21]

More significantly, as many commentators have observed, the organization of non-U.S. regulatory systems may not be well-suited to address the unique characteristics of the U.S. financial markets. Coffee and Sale identify several unique attributes of the U.S. system, including its high level of retail ownership, its level of enforcement intensity, and its reliance on equity-based compensation.[22] Other factors also make the U.S. market distinctive. As John Armour and Jeff Gordon observe, U.K. institutional ownership has traditionally been relatively homogenous, enabling regulators to rely on reputational constraints, while institutional ownership in

[19] Blueprint, supra note 6, at 3.
[20] Coffee & Sale, supra note 1, at 726.
[21] Blueprint, supra note 6, at 122–23.
[22] Coffee & Sale, supra note 1, at 727–31.

the United States is heterogeneous.[23] Moreover, U.S. law mandates greater disclosure for public companies than that of other legal systems, disclosure that has become even more extensive under Sarbanes-Oxley.[24] Finally and perhaps most significantly, the size and scope of the U.S. securities industry is dramatically larger than that of the United Kingdom (or any other country). As Don Langevoort observes, for example, in the United Kingdom approximately 8,000 individuals were authorized to conduct customer trades in 2005; in the United States, there were approximately 658,000 registered representatives in 2006.[25]

Nonetheless, Coffee and Sale support the basic proposition that regulatory consolidation is warranted and that the basic structure of a super-regulator that extends across institutional and functional lines to regulate the financial industry more broadly is desirable.[26] Significantly, Coffee and Sale approach, but do not directly address, the continued role of the SEC.

B. Regulatory Failures—The Consolidated Supervised Entities Program

Coffee and Sale come closest to addressing the continued role of the SEC when they consider the credit crisis of 2008 in an effort to determine whether the crisis reflects a regulatory failure. In their earlier draft, Coffee and Sale's analysis of the SEC's responsibility

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[23] See John Armour & Jeffrey N. Gordon, The Berle-Means Corporation in the 21st Century 29–30 (Oct. 24, 2008) (unpublished manuscript, available at http://www.law.upenn.edu/currently/seminars/businesslawscholarship/papers/Gordon.pdf).

[24] See, e.g., id. at 22 (observing that the U.K. system did not impose liability for misleading statements directed to the secondary market until 2006).

[25] Donald C. Langevoort, The SEC, Retail Investors, and the Institutionalization of the Securities Markets 8–9 (Aug. 27, 2008) (unpublished manuscript, available at http://lsr.nellco.org/georgetown/fwps/papers/80/); see also Testimony Concerning Investor Protection and Securities Fraud: Before the Subcomm. on Capital Markets, Insurance & Government-Sponsored Enterprises of the H. Comm. on Financial Services, 111th Cong. (2009) (testimony of SEC officials), available at http://www.sec.gov/news/testimony/2009/ts020409-joint.htm (explaining that, as of early 2009, there are "5,500 broker-dealers (including 173,000 branch offices and 665,000 registered representatives)" regulated by the SEC).

[26] Coffee & Sale, supra note 1, at 774.

for the crisis was somewhat equivocal.[27] That draft also considered several prior scandals—from Enron to the mutual fund timing—and largely exonerated the SEC from blame.[28] For Enron and the other pre-Sarbanes-Oxley accounting fraud, Coffee and Sale reasoned that the Financial Accounting Standards Board ("FASB") and the American Institute of Certified Public Accountants (the "AICPA") were primarily at fault, observing that industry-adopted accounting rules enabled Enron to mask its liabilities, leading to its eventual demise.[29] Similarly, with respect to the 2008 credit crisis, Coffee and Sale characterized competition among investment banks in the market for mortgage-backed investments as leading to a "mad momentum" that was unlikely to be tempered by the threat of SEC enforcement.[30] Although they conceded that the SEC had occasionally fallen behind other regulators—specifically the New York State Attorney General—with respect to the analyst scandals and mutual fund market timing, they viewed the regulatory response to these scandals less as evidence of SEC failure than of the utility of maintaining state enforcement as a safeguard against regulatory capture.[31]

In revising their original draft, Coffee and Sale's assessment of the SEC has changed. In particular, the authors now view the SEC as directly responsible, although perhaps unintentionally so, for allowing the largest investment banks to increase their levels of leverage and risk to the point that, when the market turned against them, they could not sustain their operations.[32] According to Coffee and Sale, these failures were attributable to the SEC's adoption of the Consolidated Supervised Entities Program in 2004

[27] John C. Coffee, Jr. & Hillary A. Sale, Redesigning the SEC: Does the Treasury Have a Better Idea? 16 (Sep. 4, 2008) (unpublished manuscript, on file with the Virginia Law Review Association) ("In fairness, the SEC does not deserve the primary blame.").

[28] Id.

[29] Id.

[30] Id. at 27.

[31] Id. at 17.

[32] According to Professors Coffee and Sale, the SEC "probably legitimately believed that it was gaining regulatory authority from the CSE Program (but it was wrong)." Coffee & Sale, supra note 1, at 737 n.80. Coffee and Sale also acknowledge that the SEC's failures in regulatory oversight of asset-backed securitizations "may have played a greater causal role in the debacle than has been generally emphasized. . . ." Id. at 734.

("CSE").[33] The program was a regulatory response to competitive pressure imposed by the European Union's adoption of the Financial Conglomerates Directive.[34] The CSE program, for the first time, subjected the largest U.S. investment banks to comprehensive SEC oversight in the place of the prior, more limited supervision of their broker-dealer subsidiaries. The program, however, was voluntary, and the price demanded by the investment banks for their submission to SEC oversight was high. Specifically, the banks demanded and received relaxation of the SEC's traditional net capital rules in favor of a more flexible regime modeled after the "Basel II" standards.[35]

The CSE program, which has now been terminated,[36] may appear to be an easy target—of the five banks that participated in the program, three essentially collapsed and the other two reorganized as bank holding companies.[37] All five banks dramatically increased their leverage after entry into the program, invested heavily in subprime-related real estate assets that fell substantially in value, and suffered unprecedented stock price declines.[38] Although media

[33] For a detailed description of the SEC's decision to adopt the program, see Stephen Labaton, Agency's '04 Rule Let Banks Pile Up New Debt, and Risk, N.Y. Times, Oct. 3, 2008, at A1.

[34] See id.; see also Consolidated Supervision of U.S. Securities Firms and Affiliated Industrial Loan Corporations: Before the S. Comm. on Banking, Housing, & Urban Affairs, 110th Cong. 2 (2007) (testimony of Erik Sirri, Director, SEC Division of Market Regulation), available at http://banking.senate.gov/public/_files/ACF84F7.pdf (providing historical perspective on adoption of the CSE program).

[35] Consolidated Supervision of U.S. Securities Firms and Affiliated Industrial Loan Corporations, supra note 34, at 4–5.

[36] See Press Release, Sec. & Exch. Comm'n, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), http://www.sec.gov/news/press/2008/2008-230.htm (announcing termination of the CSE program).

[37] See Associated Press, Last Big U.S. Investment Banks Change Status, Sept. 22, 2008, available at http://www.msnbc.msn.com/id/26827357/_(reporting announcement of decision by the last two investment banks, Goldman Sachs and Morgan Stanley, to become bank holding companies).

[38] Lehman Brothers, for example, closed at $36.72 on June 22, 2004 and subsequently traded at over $85 per share before filing for bankruptcy on September 15, 2008. See Andrew Ross Sorkin, Merrill is Sold: Failing to Find Buyer, Lehman Set to File for Bankruptcy, N.Y. Times, Sept. 15, 2008, at A1; Market Watch, http://www.marketwatch.com/tools/quotes/historical.asp?date=6%2F22%2F2004&symb=LEHMQ&siteid=mktw&x=12&y=4 (stock price for June 22, 2004) (last visited Feb. 2, 2009). Bear Stearns, which had traded as high as $172 per share in January, 2007, was sold to J.P. Morgan Chase in March, 2008 for $10 per share. See Landon Thomas Jr. & Eric Dash, Seeking Fast Deal, JPMorgan Quintuples Bear Stearns Bid,

reports have faulted the program for its lax standards,[39] Coffee and Sale argue that the problem was not with the rules, but with the SEC's inability to monitor the investment banks' financial exposure or to compel them to take action if the SEC identified a potential problem.[40] They note the Inspector General's finding that Bear Stearns was in compliance with the program's rules at all times prior to its near-collapse and observe that the SEC was simply outgunned in its effort to oversee the operations of the large investment banks.[41] According to one source, SEC Commissioner Paul Atkins noted that "monitoring the sophisticated models used by the brokerages under the CSE rules—and stepping in where net capital falls too low—'is going to present a real management challenge' for the SEC."[42] Similarly, the SEC's effectiveness was limited by the voluntary nature of the CSE program. As Chairman Cox conceded: "[T]he CSE program was fundamentally flawed from the beginning, because investment banks could opt in or out of supervision voluntarily. The fact that investment bank holding companies could withdraw from this voluntary supervision at their discretion diminished the perceived mandate of the CSE program, and weakened its effectiveness."[43]

These problems are peculiar to the CSE program. Thus, it is difficult to extend Coffee and Sale's analysis to a more general assessment of the SEC. Yet even within the confines of the CSE pro-

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N.Y. Times, Mar. 25, 2008, at C1; AOL Money & Finance, http://finance.aol.com/quotes/deutsche-bk-ag-ldn-brh/bsc/nys/historical-prices?tf=1%2F1%2F2007-2%2F1%2F2007&gran=d (showing that Bear Stearns traded for $172.61 on Jan. 17, 2007) (last visited Feb. 2, 2009). In 2008, "Goldman Sachs and Morgan Stanley lost more than two-thirds of their market value." Christine Harper, Goldman Sachs Shares Morgan Stanley's Darker Outlook, Bloomberg.com, Dec. 15, 2008, http://www.bloomberg.com/apps/news?pid=20601103&sid=afFOZS9odyoQ&refer=news.

[39] Commentators have also questioned whether the Basel II standard was appropriate for investment banks. See, e.g., Lee A. Pickard, Viewpoints: SEC's Old Capital Approach Was Tried—and True, Am. Banker, Aug. 8, 2008, at 10 (arguing that SEC's traditional net capital rule required less judgment and oversight to implement effectively).

[40] Coffee & Sale, supra note 1, at 740.

[41] Id.

[42] Kevin Drawbaugh, US SEC Clears New Net-Capital Rules For Brokerages, Reuters News, Apr. 28, 2004, available at http://securities.stanford.edu/news-archive/2004/20040428_Headline08_Drawbaugh.htm (citing Commissioner Atkins).

[43] Press Release, supra note 36 (quoting Chairman Cox).

gram, there is evidence that the SEC's failures were more extensive. Inspector General Kotz, in his report on Bear Stearns and the CSE program, characterized the SEC's administration of the CSE program as extremely lax.[44] The report faulted the SEC staff for identifying but failing to address significant risks at Bear Stearns such as its amount of leverage, its concentration of assets, and its risk management processes.[45] The report stated that SEC staff issued approvals before its inspection process was complete,[46] did not review filings in a timely manner,[47] and allowed Bear Stearns employees to perform critical audit work in place of outside auditors.[48] These failures raise serious questions about the SEC's internal culture and monitoring, questions that extend beyond the parameters of the CSE program and that must be answered in addressing the agency's future effectiveness. This issue will be considered in more detail in Part II below.

Coffee and Sale do not conclude from their analysis of the CSE program that the SEC is obsolete; although such a conclusion might be inferred from their support for a super-regulator. They do argue, however, that the SEC is not a suitable prudential regulator for financial institutions. They reason that such regulation should be consolidated with banking regulation and, more broadly, the regulation of financial institutions, which might include financial advisors and hedge funds as well as broker-dealers, investment banks, and commercial banks.[49] They argue that capital adequacy regulation and risk management are within the core competencies of banking regulators.[50] They also allude to the superior resources of banking regulators. In particular, they compare the Federal Reserve, which maintains an office within each regulated bank hold-

[44] Sec. & Exch. Comm'n, Office of Inspector Gen., SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program, at ix–xi (Report No. 446-A, Sept. 25, 2008), available at http://www.rgm.com/articles/SEC-BearOversightReport.pdf [hereinafter SEC Inspector General Report].

[45] Id. at 17–23.

[46] Id. at 40–41.

[47] Id. at 44–45.

[48] Id. at 34–35.

[49] Coffee & Sale, supra note 1, at 774.

[50] Id. at 775.

ing company, with the SEC in which a total of thirteen individuals staffed the office that administered the CSE program.[51]

C. Specific Blueprint Recommendations

The Blueprint's recommendations for restructuring financial regulation are extensive, and many of the proposals appear less compelling in light of recent market developments. In particular, the Blueprint's emphasis on deregulation—motivated by an effort to maintain U.S. capital market competitiveness in a global economy—must be carefully reconsidered. Such reconsideration is beyond the scope of Coffee and Sale's article, although Coffee and Sale expressly acknowledge that "excessive deregulation was a principal cause of the 2008 financial crisis."[52] Rather than taking on broader questions about the appropriate scope of financial regulation, Coffee and Sale focus on three specific Blueprint recommendations: replacing rules with principles, preempting state regulators, and increasing self regulation as a substitute for enforcement. In the Blueprint, these recommendations are integrated as part of a larger plan to reduce or eliminate the SEC and its distinctive regulatory mission, in the near term through a CFTC-SEC merger, and, in the long term, by replacing the SEC with a business conduct regulator.

1. Principles Versus Rules

It is in the context of recommending an SEC-CFTC merger that the Blueprint recommends a shift from rules to principles. The Blueprint advocates "moderniz[ation of] the SEC's regulatory approach" to incorporate the CFTC's "principles-based regulatory philosophy."[53] Coffee and Sale do not address the CFTC's regulatory principles specifically, since they deal with market regulation, prudential regulation of financial institutions, and settlement and trading practices—functions that, under Coffee and Sale's analysis, would fall largely outside of the SEC's future authority. Instead, Coffee and Sale consider rules versus standards within the context

[51] Id. at 742.
[52] Id. at 782.
[53] Blueprint, supra note 6, at 11–12.

of the current U.S. securities regime.[54] In so doing, Coffee and Sale incorporate an extensive and longstanding legal debate analyzing the trade-off between rules and standards.[55]

Coffee and Sale demonstrate compellingly that, as applied to securities regulation (to be distinguished from accounting or regulation of financial institutions), the debate over rules versus standards offers little traction. From its inception, federal securities regulation has incorporated a mixture of rules and principles. Public offering disclosure, the short swing trading provisions of Section 16, and the traditional broker-dealer net capital provisions are examples of the rules-based approach. Federal securities fraud under SEC Rule 10b-5 is a principles-based regulatory approach. Coffee and Sale accurately characterize the existing system as a hybrid in which a combination of rules and principles attempts to achieve both predictability and flexibility.[56] Moreover, they show that, from an industry perspective, the hybrid system is desirable.[57] Although persuasive arguments can be made in favor of shifting the approach along the rules/principles continuum with respect to a specific regulatory issue, a wide scale shift in either direction is likely to be both unproductive and politically infeasible.

Coffee and Sale also consider the implications of a principles-based approach in the context of an enforcement-oriented regulatory system. They criticize the Blueprint for failing to identify the potential impact of a principles-based approach on civil liability exposure, arguing that a principles-based approach increases litigation uncertainty and settlement pressure, placing increased strain on a litigation system that is already controversial.[58] The same argument has been extended beyond private civil liability to public enforcement. Former SEC Chair Harvey Pitt and Karen Shapiro, for example, criticized the SEC's actions against insider trading as

[54] Coffee & Sale, supra note 1, at 749.
[55] The seminal article on this topic is Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 Duke L.J. 557 (1992). In securities regulation, one of the most comprehensive treatments is James J. Park, The Competing Paradigms of Securities Regulation, 57 Duke L.J. 625 (2007).
[56] Coffee & Sale, supra note 1, at 718.
[57] Id. at 757.
[58] Id. at 757–58.

"regulation by enforcement."[59] They claimed that the SEC's ad hoc efforts to define wrongful conduct through enforcement actions provided targets with insufficient notice and that norms should instead be generated through rulemaking.[60]

2. Preemption of State Regulation

Coffee and Sale next consider the Blueprint's recommended preemption of state regulation. The Blueprint's recommendation is threefold.[61] First, it advocates bringing a wide range of financial service providers within the regulatory authority of its new business conduct regulator, the Conduct of Business Regulatory Agency ("CBRA").[62] The Blueprint further argues that the CBRA should adopt national standards for business conduct that "would apply to all financial services firms, whether federally or state-chartered" and "preempt[] state business conduct laws."[63] Finally, the Blueprint articulates a narrow role for state regulators in enforcing these standards—optimally, according to the Blueprint, state regulators could bring issues to the CBRA's attention and, if authorized to do so, proceed to investigate and enforce the standards.[64]

Coffee and Sale do not fully explore the recommendation for the adoption of national standards.[65] Instead they focus on, and defend, the states' role in enforcement. They note the responsiveness of state regulators—particularly the New York Attorney General—to

[59] See generally Roberta S. Karmel, Regulation by Prosecution: The Securities and Exchange Commission vs. Corporate America (1982); Harvey L. Pitt & Karen L. Shapiro, Securities Regulation by Enforcement: A Look Ahead at the Next Decade, 7 Yale J. on Reg. 149 (1990).

[60] See Pitt & Shapiro, supra note 59, at 288 (warning of "possibility that enforcement proceedings will become a substitute for formal regulation").

[61] The Blueprint is somewhat ambiguous on the precise role contemplated for state enforcement and, in its most detailed section, offers several possible alternative state roles in rulemaking and enforcement. See Blueprint, supra note 6, at 179–80.

[62] Id. at 145. Significantly, the Blueprint identifies a fourth regulator—a corporate finance regulator that would hold the SEC's current responsibilities with respect to corporate disclosures and corporate governance—but the Blueprint does not detail the relationship among the corporate finance regulator and its other proposed regulators. Id.

[63] Id. at 20.

[64] Id. at 180.

[65] As the Blueprint notes, existing law already preempts most state regulation of securities-related transactions. Id. at 178.

analyst conflicts of interest, the mutual fund timing scandals, and most recently, auction-rate securities.[66] As these examples demonstrate, state regulators have served as a valuable backstop in cases of federal regulatory failure, particularly failure in the regulation of financial institutions. Other research documents the value of state enforcement efforts in greater detail.[67] Significantly, state regulators have often played an important role in the protection of retail investors—a role traditionally within the core competency of the SEC, but that has received diminished SEC attention in recent years.[68]

The Blueprint does not attempt to justify its recommendation that state enforcement activity be preempted, nor is preemption the inevitable consequence of establishing uniform federal standards. Indeed, the recent state investigative and enforcement actions detailed by Coffee and Sale addressed conduct that violated federal as well as state law. Oddly enough, however, Coffee and Sale appear sympathetic to the Blueprint's recommendation, reasoning that, theoretically, a state regulator "could take action under antifraud rules that did conflict with important federal regulatory policies."[69] As a result, they suggest an alternative to outright preemption that would empower the SEC to invalidate state regulatory actions that conflicted with federal policy on a case-by-case basis.[70] Although Coffee and Sale's solution is superior to complete preemption, the recent and continuing history of securities-related scandals and SEC failures offers little reason to cut back even minimally on state enforcement efforts.

3. Increased Reliance on SROs

Finally, Coffee and Sale consider the Blueprint's recommendation that increased regulatory authority be transferred from the

[66] Coffee & Sale, supra note 1, at 713.

[67] See, e.g., William Francis Galvin, White Paper, States' Demonstrated Record of Effectiveness In Their Investor Protection Efforts Underscores the Need to Avoid Further Preemption of State Enforcement Authority (Dec. 10, 2008), available at http://www.sec.state.ma.us/sct/sctwhitepaper/Secretary_Galvin_Enforcement_White_Paper.pdf (describing the role of the states in initiating enforcement actions and providing recovery to victims of substantial securities frauds over past ten years).

[68] Id. at 7.

[69] Coffee & Sale, supra note 1, at 760.

[70] Id. at 780.

SEC to the self regulatory organizations ("SRO"). This recommendation perhaps most clearly exposes the deregulatory agenda behind the Blueprint's proposals, and Coffee and Sale identify many reasons why SRO regulation cannot offer meaningful protection of investors and the markets. First, as indicated earlier, there is the lesson of the U.K. experience in which the SRO model failed. Significantly, a major component of the failure was the "inability or unwillingness" of the SROs to protect investors from "fraud and misconduct."[71] Although the SROs may have a comparative advantage in formulating rules that address back office procedures and market infrastructure, their incentives are to serve the interests of their constituencies—listed companies, broker-dealers, and as Coffee and Sale observe, for publicly traded SROs, their own investors.[72] There is little reason to believe that the SROs would benefit from aggressively enforcing securities regulations that did not further those constituent interests. Indeed, experience shows that the SROs have behaved as predicted. The New York Stock Exchange, for example, monitors potential insider trading through stock watch, because insider trading hurts its specialists.[73] With respect to analyst disclosure provisions, where misconduct hurt investors but not brokers, however, the SROs failed to enforce clear regulatory directives.

Increased reliance on the SROs is also inconsistent with the Blueprint's primary justification for regulatory reform. The existence of multiple SROs with overlapping jurisdiction does not consolidate the regulatory functions; instead, it increases the potential for fragmentation. At the same time, the existing SROs lack jurisdiction over many participants in the securities markets, including investment advisors, investment companies, hedge funds, and unlisted issuers, creating the potential for continued regulatory gaps. Forces such as technological innovation and globalization continue to offer market participants alternative mechanisms for accessing capital, allowing issuers and others to exit from onerous

[71] Id. at 722–23.

[72] Id. at 772–73.

[73] See, e.g., NYSE Regulation, About NYSE Regulation, Market Surveillance, http://www.nyse.com/regulation/nyse/1045516499685.html (explaining how "[t]he Stock Watch unit of Market Surveillance . . . detect[s] possible insider trading and market manipulation").

SRO regulations.[74] As a result, the SRO's oversight in the future will likely resemble the type of voluntary regulation that proved unsuccessful in the CSE program.

Perhaps most problematic is the Blueprint's failure to establish that current SRO regulation works. As Coffee and Sale explain, the SEC currently delegates primary oversight of broker-dealers to FINRA.[75] Yet few of the details of FINRA's investigations, its disciplinary actions, and even its customer arbitrations are transparent.[76] Although it issues press releases in a few high profile cases, in most cases FINRA provides only summary statistics—maintaining its investigations, case resolutions, and even customer complaints, as confidential. Indeed, FINRA reporting and record-keeping provisions affirmatively facilitate the concealment of allegations of misconduct.[77]

Although it is difficult to ascertain the effectiveness of FINRA's oversight from its disclosures, there have been obvious shortcomings.[78] For example, FINRA's record in addressing research analyst

[74] Coffee & Sale, supra note 1, at768. See, e.g., Chris Brummer, Stock Exchanges and the New Markets for Securities Laws, 75 U. Chi. L. Rev. 1435, 1459–66 (2008) (describing technological innovations such as electronic trading, and explaining how such innovations reduce barriers to entry into the trading markets).

[75] Coffee & Sale, supra note 1, at 768–69.

[76] See, e.g., Robert Kuttner, A Tame Regulator for the SEC, Am. Prospect, Dec. 18, 2008, http://www.prospect.org/cs/articles?article=a_tame_regulator_for_the_sec (observing that FINRA "has little transparency").

[77] See Financial Industry Regulatory Authority, FINRA Manual, Rule 2130 (Apr. 12, 2004) (allowing expungement of customer disputes upon issuance of a court order or arbitration award); see, e.g., FINRA Can't Tell Investors What They Most Want to Know, http://investorswatchdog.com/blog/investorswatchblog/?p=15 (Nov. 16, 2007, 19:32) (describing expungement). FINRA adopted rule changes in 2004 to make expungement more difficult. See Lynnley Browning, Site That Tracks Brokers Questioned on Erased Cases, N.Y. Times, Dec. 14, 2007, at C10 (describing new rules providing that arbitrators can expunge a broker's record "only if an arbitration panel found that an investor's allegations had been factually impossible or false, or that the accused broker had not been individually involved in the matter"); see also FINRA Considers Change to Rule Regarding Sales Practice Violations by Brokers, Insurance & Financial Advisor Webnews, Apr. 30, 2008, http://www.ifawebnews.com/articles/2008/05/06/news/life/doc4817358786a95404744546.txt (describing FINRA reporting requirement enabling allegations of sales practice violations that do not name a specific broker to remain "unavailable to regulators, to prospective broker-dealer employers and to the investing public through FINRA BrokerCheck").

[78] Mary Schapiro, then-CEO of FINRA, disclaimed responsibility for failing to uncover the Madoff fraud, stating that FINRA lacked jurisdiction over investment advisors; see, e.g., Dan Jamieson, Finra Had Authority in Madoff Matter, Legal Eagles

conflicts of interest has been criticized.[79] More recently, the auction-rate securities scandal suggests the possibility of serious and widespread oversight deficiencies. Auction-rate securities are typically long term bonds with fluctuating interest rates. The interest rates are reset periodically by auctions that also provide liquidity for investors.[80] If investor demand for the securities at an auction is insufficient, the interest rate is reset to a penalty rate, but the investor may not be able to liquidate its position. According to media reports of the scandal, the leading investment banks sold billions of dollars of these securities by representing that they were near-cash equivalents, failing to disclose to investors the liquidity risk of a failed auction. Moreover, the banks allegedly concealed the extent of the liquidity risk by secretly propping up failed auctions by purchasing the securities themselves.[81]

Even though the auction-rate securities market existed for twenty years, and the recent allegations suggest widespread misrepresentations, misleading sales practices, violations of suitability requirements, and outright fraud, FINRA seemingly did not detect the problem through its supervision of the brokers involved. Indeed, FINRA did not even address the issue until after widespread auction failures left thousands of investors holding illiquid securi-

Say, Investment News, Jan. 25, 2009, available at http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20090125/REG/301259989 (describing Schapiro's testimony to Senate Banking Committee). Critics have disputed this claim, arguing that FINRA's review of the broker-dealer's records should have revealed the fraud. See id. (describing dispute over FINRA's oversight role). More recently, FINRA has been criticized for missing a massive fraud allegedly spanning more than a decade at the Stanford Group. Jesse Westbrook & Ian Katz, Finra's Stanford Probe Raises Questions on Oversight, Bloomberg.com, Feb. 18, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=ahaUscXNr5wY&refer=home. Despite having uncovered regulatory violations at Stanford through the exercise of its inspection authority, FINRA failed to detect the scope of the fraud and merely imposed a $10,000 fine. Id.

[79] Jill E. Fisch & Hillary A. Sale, The Securities Analyst as Agent: Rethinking the Regulation of Analysts, 88 Iowa L. Rev. 1035, 1043–45 (2003) (reporting findings that NYSE and NASD failed to enforce rules governing analyst conflicts of interest effectively).

[80] See, e.g., Stephanie Lee, Auction-Rate Securities: Bidder's Remorse?, 4 Pratt's J. Bankr. L. 585 (2008) (explaining financial structure of auction-rate securities).

[81] Liz Rappaport & Randall Smith, UBS to Pay $19 Billion As Auction Mess Hits Wall Street, Wall St. J., Aug. 9–10, 2008, at A1. The Journal reported that UBS may have submitted bids in almost 70% of its auctions between January 2006 and February 2008. Id.

ties.[82] Even then, FINRA initiated a "fact-finding sweep" rather than an enforcement action.[83] In contrast, New York State Attorney General Andrew Cuomo launched an industry probe into auction-rate securities in April 2008 that included issuing subpoenas to eighteen Wall Street firms.[84] The efforts of Cuomo and other state regulators were subsequently coordinated with the SEC and FINRA and recovered billions of dollars for investors.[85]

FINRA also maintains a dispute resolution system that, under the Blueprint's approach, would likely displace most private investor litigation.[86] The FINRA arbitration system is currently the exclusive method of resolving virtually all broker-customer disputes, from suitability to wrongful execution to fraud. For years, critics have charged that the system is biased in favor of the industry, yet FINRA has failed to provide sufficient transparency to test this claim empirically.[87] The SEC, charged with protecting investors,

[82] Lynn Hume & Andrew Ackerman, SEC, FINRA Probing ARS Sales: Misrepresentations of Risk Alleged, Bond Buyer, Apr. 11, 2008, at 1 (stating that FINRA's probes began over the past two weeks in response to hundreds of investor complaints). But cf. Testimony Concerning Auction Rate Securities Markets: Before the H. Comm. on Financial Services, 110th Cong. 2 (2008) (testimony of Susan Merrill, FINRA Chief of Enforcement), available at http://financialservices.house.gov/hearing110/merrill091808.pdf (describing FINRA information gathering as consisting of a survey of two hundred firms in late February, followed by a sweep letter to two dozen firms in early spring).

[83] Hume & Ackerman, supra note 82, at 2.

[84] Vikas Bajaj, Inquiries Into Auction-Rate Securities Widen, N.Y. Times, Apr. 18, 2008, at C6.

[85] See, e.g., Press Release, Office of the Attorney General, Attorney General Cuomo Announces Settlements with Bank of America and Royal Bank of Canada to Recover Billions for Investors in Auction-Rate Securities (Oct. 8, 2008), http://www.oag.state.ny.us/media_center/2008/oct/oct8a_08.html (reporting recovery of $51 billion as of Oct. 8, 2008).

[86] Indeed, some have advocated displacing securities fraud class actions with arbitrations. See, e.g., Steven A. Ramirez, Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous, 40 Wm. & Mary L. Rev. 1055, 1060–62 (1999) (proposing extending arbitration to most private securities fraud claims).

[87] See, e.g., Jill Gross & Barbara Black, Report to the Securities Industry Conference on Arbitration, Perceptions of Fairness of Securities Arbitration: An Empirical Study (Feb. 6, 2008), available at http://digitalcommons.pace.edu/lawfaculty/478 (empirically studying investor perceptions of fairness in arbitration process); Gretchen Morgenson, Is This Game Already Over?: Critics Say Arbitration Panels Often Have Hidden Conflicts, N.Y. Times, June 18, 2006, § 3 (Sunday Business), at 1 (reporting criticisms of arbitration process including industry domination, arbitrator bias, and inadequately disclosed conflicts of interest).

has made little effort to determine the adequacy of FINRA arbitration as a remedy for broker misconduct.

II. HAS THE SEC FAILED TO REGULATE EFFECTIVELY?

For the most part, Coffee and Sale's article is appropriately skeptical of the Blueprint's recommendations. The credit crisis, however, makes the evaluation of the SEC far more compelling. Ultimately, Coffee and Sale's article just is not tough enough, although Professor Coffee has concededly addressed other aspects of the SEC's failures elsewhere.[88] If the SEC has failed to regulate effectively, the CSE program, which dealt with just five companies—albeit five very economically significant companies—is just a piece of the story.

The absence of SEC leadership throughout the financial crisis is perhaps the most significant aspect of the failure. For decades the SEC has been known as the top cop on Wall Street, yet, when the crisis hit, members of the Commission remained silent. The *Wall Street Journal* excoriated Chairman Cox for his lack of involvement in the emergency forced sale of Bear Stearns,[89] and while its criticisms may have been excessive, the fact remains that the SEC showed limited responsiveness.[90]

Virtually the only publicly visible action taken by the SEC as the crisis unfolded was the adoption of several restrictions on short selling. In July, 2008, the SEC announced an immediate emergency

[88] See, e.g., John C. Coffee, Jr., Commentary: Where was the SEC?, CNNPolitics.com, Dec. 17, 2008, http://www.cnn.com/2008/POLITICS/12/16/coffee.madoff/ (stating that "considerable evidence suggests [the SEC] was asleep at the switch" with respect to the Madoff fraud).

[89] Kara Scannell & Susanne Craig, SEC Chief Under Fire as Fed Seeks Bigger Wall Street Role: Cox Draws Criticism for Low-Key Leadership During Bear Crisis, Wall. St. J., June 23, 2008, at A1.

[90] For a comprehensive list of SEC actions taken in response to the credit crisis, see Sec. & Exch. Comm'n, SEC Actions During Turmoil in Credit Markets, available at http://www.sec.gov/news/press/sec-actions.htm (listing actions taken). In addition, at least with respect to its oversight of Bear Stearns, the SEC apparently attempted to cover up the Inspector General's findings of misconduct. Bloomberg News reported that, pursuant to requests from the SEC Office of Trading and Markets, the Inspector General deleted extensive material from his report before it was released to the public. See Mark Pittman, Elliot Blair Smith & Jesse Westbrook, Cox's SEC Censors Report on Bear Stearns Collapse, Bloomberg.net, Oct. 7, 2008, http://www.rgm.com/articles/bloomberg11.html (describing deletion of 136 references).

order banning short selling in the stock of nineteen financial firms.[91] The ban lasted approximately three weeks.[92] Subsequently, the SEC expanded its restrictions; on September 19, 2008, it announced a temporary ban on selling short the stock of 799 financial companies.[93] Finally, the SEC adopted non temporary rules that require large traders to disclose their short selling.[94] The SEC touted its actions as addressing "market manipulation that threatens investors and capital markets."[95] In adopting the September 19 ban, Chairman Cox explained that "[t]he emergency order temporarily banning short selling of financial stocks will restore equilibrium to markets."[96] Instead, from September 19, 2008, to October 9, 2008, stock prices fell by approximately 25%.[97] Indeed, in December 2008, Cox described the short selling ban as "the biggest mistake of his tenure."[98]

Empirical scholars are still assessing the precise effects of the bans, but early evidence suggests that they did not achieve the desired objectives. According to the studies, the bans were not warranted by excessive short selling activity, and short selling did not

[91] Emergency Order Pursuant to Section 12(k)(2) of The Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,166, [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,247 (July 15, 2008).

[92] See Marcy Gordon, SEC's Ban on Short-Selling Fannie, Freddie Ends, USA Today, Aug. 12, 2008, http://www.usatoday.com/money/markets/2008-08-12-sec-short-selling-ban_N.htm (describing ban as lasting from July 21, 2008 through August 12, 2008).

[93] Press Release, Sec. & Exch. Comm'n, SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets (Sept. 19, 2008), http://www.sec.gov/news/press/2008/2008-211.htm. The initial duration of the ban was ten business days. Id. Both the duration of the ban and the number of issuers covered were subsequently increased.

[94] Order Amending and Extending Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,724, [2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 88,292 (Oct. 2, 2008).

[95] Press Release, supra note 93 (quoting Chairman Cox).

[96] Id.

[97] The adjusted Dow Jones Industrial Average fell from an adjusted closing price of 11,388.44 on September 19, 2008, to 8,579.19 on October 9, 2008. Yahoo! Finance, Dow Jones Industrial Average Historical Prices, http://finance.yahoo.com/q/hp?s=^DJI (enter September 19, 2008, as start date and October 9, 2008, as end date).

[98] Amit R. Paley & David S. Hilzenrath, SEC Chief Defends His Restraint, Wash. Post, Dec. 24, 2008, at A1 (quoting interview with Chairman Cox).

contribute materially to stock price declines. At the same time, stocks that were subject to the bans suffered increased volatility, lower prices, and dramatically reduced liquidity.[99] In one of the most comprehensive studies to date, Arturo Bris examined the effect of the July 2008 emergency order.[100] Bris found that the order reduced both liquidity and market efficiency. In addition, the nineteen stocks subject to the ban experienced ten percent worse performance than other U.S. financial stocks.[101] A quick study of the September ban by NASDAQ chief economist Frank Hatheway found that liquidity of the stocks subject to the ban was "about half what it was before the ban—a far greater evaporation of market depth than occurred with other stocks."[102]

The short selling bans were a response to deteriorating market conditions. More problematic were the SEC's activities in the months preceding the crash. An example is the SEC's ongoing consideration of the move to international financial accounting standards ("IFRS"). The SEC engaged in a multi-year project in which it repeatedly promised to allow U.S. companies to use IFRS instead of GAAP.[103] The market crisis likely delayed this move, but more important, it called into question the justifications for the move.[104] IFRS offers issuers greater discretion with respect to fi-

[99] Arturo Bris, Short Selling Activity in Financial Stocks and the SEC July 15th Emergency Order (Working Paper Dated Aug. 12, 2008), available at http://www.arturobris.com/eo/brisreportAug12.pdf. But see Ian W. Marsh & Norman Niemer, The Impact of Short Sales Restrictions (Working Paper Dated Nov. 30, 2008), available at http://www.cass.city.ac.uk/media/stories/resources/the-impact-of-short-sales-restrictions.pdf (studying short selling bans introduced by seventeen countries and finding little impact in terms of either returns or efficiency).

[100] Bris, supra note 99.

[101] Id.

[102] David Greising, Short-Selling Ban Leaves SEC with Little to Show, Chi. Trib., Oct. 10, 2008, at 37 (reporting results of Hatheway study).

[103] Press Release, Sec. & Exch. Comm'n, SEC Takes Action to Improve Consistency of Disclosure to U.S. Investors in Foreign Companies (Nov. 15, 2007), http://www.sec.gov/news/press/2007/2007-235.htm.

[104] Sec. & Exch. Comm'n, Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers (proposed rule which would require domestic issuers to convert to IFRS by 2014); Rules and Related Matters: SEC Publishes Proposed IFRS "Roadmap," SEC News Digest, Issue 2008–223 (Nov. 18, 2008). In November 2008, the SEC released a roadmap under which domestic issuers would be required to convert to IFRS by 2014. See Marie Leone, SEC Chief Accountant Plans His Exit, CFO.com, Nov. 25, 2008, http://www.cfo.com/article.cfm/12673473.

nancial reporting, thus reducing financial statement transparency. This objective appears far more problematic in an environment characterized by widespread mistrust of accounting numbers. As Public Company Accounting Oversight Board ("PCAOB") member Charles Niemeier has warned, IFRS might undermine U.S. regulation of financial reporting by introducing a system that is more difficult to enforce.[105] Thus, in addition to reducing transparency, IFRS would be deregulatory.

If IFRS threatens to reduce financial transparency, so does the effort to suspend fair value accounting. Fair value accounting requires firms to report the current or fair value of their assets rather than historical price. In most cases, this requires firms to mark their assets to market.[106] The SEC has advocated fair value accounting since as early as 2000—before the spectacular collapse of Enron.[107] In recent months, however, the fair value mandate has come under vigorous attack. Financial firms have struggled with the application of accounting rules to value troubled assets in volatile markets. In some cases, lack of marketability has required firms to report substantially reduced values.

These problems led to extensive political efforts to relieve the mandate and to allow firms greater discretion in valuing troubled assets such as collateralized mortgage obligations and credit default swaps. Defenders of fair value accounting argue that it must be retained in order to enable a return of trust to the markets.[108]

[105] Marie Leone, Regulator Rips into Global Accounting Plan, CFO.com, Sept. 10, 2008, http://www.cfo.com/printable/article.cfm/12202211/c_12207327?f=options (quoting Charles Niemeier as stating that "[t]he rush to adopt international accounting standards is a politically motivated, myth-ridden effort that will weaken U.S. capital markets").

[106] Exchange price is defined as "the price in an orderly transaction between market participants." Financial Accounting Standards Board, Fair Value Measurements, Statement of Financial Accounting Standards (SFAS) No. 157, at 2 (Sept. 2006).

[107] Jackson M. Day, Deputy Chief Accountant, Sec. & Exch. Comm'n, Fair Value Accounting—Let's Work Together and Get It Done!, Remarks at 28th Annual National Conference on Current SEC Developments (Dec. 5, 2000), available at http://www.sec.gov/news/speech/spch436.htm (explaining that "[a]ll financial instruments should be measured at fair value [and] [t]hose measurements should be reliable and transparent").

[108] The joint statement of the Center for Audit Quality, the Council of Institutional Investors, and the CFA Institute issued on October 1, 2008, strongly opposes any suspension of fair value accounting, noting that it "would deprive investors of critical financial information when it is needed most." Joint Statement of the Center for Audit

Ensuring appropriate financial transparency is at the core of the SEC's traditional expertise and, in fact, the Emergency Economy Stabilization Act of 2008 responded to the lobbying efforts of banks and others by authorizing the SEC to suspend fair value accounting as necessary.[109] Although it does not currently appear that the SEC will suspend fair value accounting, the Commission has done little to stem the controversy.[110] At a minimum, the SEC could explain to critics that mark-to-market, like short selling, is an inappropriate fall-guy.[111] Under the current rules, banks mark a small percentage of their assets to market—most assets are carried at historical cost.[112] Moreover, the market has clearly shown that it does not believe currently reported valuations.[113] The SEC's failure to respond and the possibility that accounting rules could be modified in response to political pressure continue to threaten public confidence.[114]

The SEC's involvement in IFRS and fair value accounting contrasts with its spotty record on perhaps the most critical accounting issue of the credit crisis: derivatives regulation. Despite the enormous risks posed by derivatives, both to the viability of major U.S.

Quality, the Council of Institutional Investors, and CFA Institute Opposing Suspension of Mark-to-Market Accounting, Oct. 1, 2008, available at http://www.cfainstitute.org/aboutus/press/release/08releases/20081001_01.html.

[109] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008). Section 132 of the Act grants the SEC authority to suspend fair value accounting for any issuer or with respect to any class or category of transaction.

[110] Indeed, shortly before this article went to press, FASB relaxed mark-to-market accounting rules. See, e.g., Francesco Guerrera, Don't Eat Wall Street's Big Fudge - it's a Dog's Breakfast, Fin. Times, Apr. 4, 2009, at 15 (describing FASB's rule change). Media reports attributed the move to political pressure; as the Financial Times stated: "A few choice words from politicians was all it took for the fearless members of the accounting watchdog to turn from staunch defenders of 'fair value' to advocates of the more 'flexible' approach so beloved by banks . . . ." Id.

[111] See, e.g., Merrill Lynch, Does TARP Point to Suspension of Mark-to-Market?, Industry Overview, Oct. 24, 2008 (on file with the Virginia Law Review Association) (describing mark to market accounting as a "red herring" and stating that "the problem is just plain old bad loans, in massive amounts").

[112] See David Reilly, Going on Offense With Mark-to-Market, Wall St. J., Dec. 19, 2008, at C10 (explaining that, of 17 banks seized by the FDIC this year, only ten percent of their average total assets were marked to market).

[113] Id. (citing RiskMetrics Group study finding that "59% of publicly traded bank-holding companies trade below their third-quarter net worth, or book value").

[114] Marine Cole, Bailout Offers Fair-Value Out, Fin. Wk., Oct. 5, 2008, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20081005/REG/810039953.

public issuers and to the transparency of their financial statements, the SEC yielded to industry and political claims that derivatives trading did not require regulatory oversight.[115] In the Shad-Johnson Accord, the chairmen of the SEC and the Commodities Futures Trading Commission ("CFTC") resolved a jurisdictional dispute over derivatives regulation by agreeing that the SEC would retain jurisdiction only over securities and options on securities.[116] Most other derivative products, including credit default swaps ("CDS") and futures contracts, would be regulated by the CFTC.[117] The CFTC proceeded to exempt a variety of products from regulation and these exemptions were expanded by the Commodity Futures Modernization Act of 2000,[118] which exempted most over-the-counter derivatives trading from both securities and commodities regulation.[119] Rather than anticipating the risks associated with the

[115] The risks associated with derivatives received widespread public attention in 1994, when Gibson Greetings and Proctor and Gamble suffered highly publicized losses from derivatives trading. See, e.g., Int'l Fin. Risk Inst., Risk Mitigation Overview: Sales Practices, http://riskinstitute.ch/134730.htm (describing "seachange" in regulatory attention to derivatives occurring in 1994). Policymakers considered several regulatory reforms aimed at addressing the potential risks, but the reforms were not adopted. See Christopher L. Culp & Robert J. Mackay, Regulating Derivatives: The Current System and Proposed Changes, 17 Reg. 38, 42–50 (1994) (describing reform proposals).

[116] CFTC and SEC Jurisdictional Agreement: Proposed Legislation, Comm. Fut. L. Rep. (CCH) ¶ 21,332 (Feb. 2, 1982). The Shad-Johnson Accord was codified in the Securities Acts Amendments of 1982, 15 U.S.C. § 77b(1) (2006) (§ 2 of the Securities Act of 1933) and 15 U.S.C. § 78c (2006) (§ 3 of the Securities Exchange Act of 1934) (1983) and in the Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1983).

[117] Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1983) (codified at various sections of 7 U.S.C.).

[118] Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, § 1(a)(5), 114 Stat. 2763, 2763A-365 (codified at 7 U.S.C. §§ 1–27 (2006)). The CFMA was adopted in response to a recommendation by a joint Treasury, CFTC, Federal Reserve, and SEC working group, which determined that increased regulation of derivatives was unnecessary. President's Working Group on Fin. Mkts., Over-the-Counter Derivatives Markets and the Commodity Exchange Act 15–23 (Nov. 1999), available at http://www.ustreas.gov/press/releases/reports/otcact.pdf.

[119] The exemption was limited to transactions involving institutions or sophisticated individual investors. See Jerry W. Markham, Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan, 28 Brook. J. Int'l L. 319, 369 (2003) (describing this exemption as the "Enron [A]mendment"). The CFMA also amended the federal securities laws to provide explicitly that swap agreements, including security-based swap agreements, are not "securities." Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554,

growth of credit derivatives or espousing conservatism until those risks could be assessed, the SEC joined in the effort to create the regulatory gap that it now appears to regret.[120] As Chairman Cox testified before the Senate Committee on Banking, Housing, and Urban Affairs in September 2008, "[t]he $58 trillion notional market in credit default swaps—double the amount that was outstanding in 2006—is regulated by no one. Neither the SEC nor any regulator has authority over the CDS market, even to require minimum disclosure to the market."[121]

The SEC does not deserve exclusive blame for its failure to identify the risks associated with derivatives. Well-respected commentators claimed for years that derivatives posed no risks warranting increased regulatory oversight.[122] Moreover, the SEC did make an effort to improve the transparency of derivatives transactions by adopting targeted disclosure requirements. In 1997, over many commentators' objections,[123] the SEC promulgated Item 305 to Regulation S-K, the so-called "Market Risk Rule,"[124] which singled out derivatives for special risk disclosure in corporate financial statements.[125] Item 305 requires public companies to disclose the

§ 1(a)(5), 114 Stat. 2763, 2763A-365 (codified at 15 U.S.C. §§ 77b-1(a), 78c-1(a) (2006)).

[120] Ironically, the lone critic of the deregulatory approach was then-CFTC chair Brooksley Born. See Anthony Faiola, Ellen Nakashima & Jill Drew, What Went Wrong, Wash. Post, Oct. 15, 2008, at A1 (describing Born's unsuccessful efforts to increase regulation of derivatives in 1998).

[121] Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing Before the S. Comm. on Banking, Housing, & Urban Affairs, 110th Cong. 6 (Sept. 23, 2008) (testimony of Christopher Cox, Chairman, Sec. & Exch. Comm'n).

[122] For example, Nobel prize winner Merton Miller stated: "[N]o serious danger of a derivatives-induced financial collapse really exists." Merton H. Miller, Do We Really Need More Regulation of Financial Derivatives?, Address at the Inauguration of the International Executive M.B.A. Program at Barcelona Conducted by the University of Chicago Graduate School of Business (Oct. 17, 1994) (published as Selected Paper Number 75, Univ. Chi. Graduate Sch. Bus.), available at http://www.chicagogsb.edu/faculty/selectedpapers/sp75.pdf.

[123] See, e.g., Martin H. Dozier, Note, Barings's Ghost: Item 305 in SEC Regulation S-K and "Market Risk" Disclosures of Financial Derivatives, 34 Ga. L. Rev. 1417 (2000) (criticizing Item 305).

[124] 17 C.F.R. § 229.305 (2008).

[125] See Dozier, supra note 123, at 1447–51 (describing circumstances leading to the SEC's adoption of the Market Risk Rule).

risks associated with their derivatives positions in the Management Discussion and Analysis section of their financial statements.[126]

It is unclear why the SEC's disclosure efforts failed to maintain investor confidence in the transparency of the financial statements issued by the financial institutions that maintained large positions in derivatives.[127] Perhaps, as Professor Schwarcz has argued, disclosure requirements are an ineffective regulatory response to complex financial instruments.[128] Perhaps the disclosure requirements were insufficiently stringent. And perhaps the critical response to its rules led SEC officials to undertake equivocal enforcement efforts that failed to render the disclosure requirements effective.[129]

Enforcement of disclosure requirements is a critical component of the SEC's mission,[130] and recent events reveal substantial failures in this area as well. The most dramatic example is the SEC's failure to detect the massive fraud at Bernard Madoff Investment Securities, LLC. Madoff's investment business apparently operated as a massive Ponzi scheme for more than a decade, ultimately causing investors to lose as much as $50 billion.[131] SEC Chairman Cox ad-

[126] Id. at 1450–51 (describing the scope of disclosure requirements).

[127] The markets continue to reflect a distrust of publicly reported valuation numbers. See, e.g., Jonathan Weil, Wachovia Shows Why No Bank's Books Are Trusted, Bloomberg.com, Oct. 30, 2008, http://www.bloomberg.com/apps/news?pid=20601039&refer=columnist_weil&sid=aZE9yF3JayDA (describing the Wachovia board's approval of the company's sale to Wells Fargo for $14.8 billion despite its reported asset value of $50 billion).

[128] See Steven L. Schwarcz, Rethinking the Disclosure Paradigm in a World of Complexity, 2004 U. Ill. L. Rev. 1, 10–11 (2004) (questioning the effectiveness of disclosure requirements as a response to financial complexity).

[129] The SEC administered the Market Risk Rule with a strikingly "light touch." See, e.g., Sec. & Exch. Comm'n, Sample Letter Sent to Public Companies That Have Identified Investments in Structured Investment Vehicles, Conduits or Collateralized Debt Obligations (Off-balance Sheet Entities) (Dec. 2007), http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm (providing a sample letter sent by the SEC's Division of Corporate Finance to issuers involved with SIVs and CDOs that did not impose any mandates but merely "highlight[ed] some of the disclosure issues that [they] may want to consider" in preparing their upcoming securities filings).

[130] See, e.g., Howell E. Jackson, Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications, 24 Yale J. on Reg. 253, 265–86 (2007) (describing the regulatory effort and enforcement intensity of the SEC).

[131] According to the SEC's complaint, Madoff's business had been insolvent for years and had been paying returns to some investors out of the principal invested by other investors. Complaint at 6, Sec. & Exch. Comm'n v. Madoff, No. 08-10791

mitted that the SEC had received "[c]redible and specific allegations regarding Madoff's financial wrongdoing going back to at least 1999."[132] The SEC investigated Madoff's operations in 2006 and found that Madoff misled SEC staff and withheld documents.[133] Unlike Martha Stewart, however, who was sent to jail for lying to federal investigators, Madoff was not sanctioned, and the SEC closed the case, concluding that Madoff's digressions were not serious enough to warrant an enforcement action.[134] Some commentators have attributed the SEC's regulatory failures to the unwillingness of SEC staff to be sufficiently vigilant in dealings with "prominent Wall Street insiders."[135] Others blame demoralization of the staff of an agency that is more concerned with deregulation than with active oversight.[136]

The Madoff case may not be an isolated example of regulatory failure. In addition to his report on the SEC's supervision of Bear Stearns under the CSE Program, SEC Inspector General Kotz released a second report stating that in 2005, two years before problems began to surface at Bear Stearns, the SEC's Miami office found that Bear Stearns employees had improperly inflated the value of certain mortgage-related securities.[137] It is worth noting

(S.D.N.Y. Dec. 11, 2008), available at http://sec.gov/litigation/complaints/2008/comp-madoff121108.pdf.

[132] Congress Plans, supra note 7. Cox placed responsibility on SEC staff, claiming that they failed to follow up appropriately. Id.

[133] Gregory Zuckerman & Kara Scannell, Madoff Misled SEC in '06, Got Off, Wall St. J., Dec. 18, 2008, http://online.wsj.com/article/SB122956182184616625.html?mod=djemalertNEWS.

[134] Sec. & Exch. Comm'n, Div. of Enforcement, Case Closing Recommendation, Case No. NY-07563 (Nov. 21, 2007), available at http://online.wsj.com/public/resources/documents/Madoff_SECRecommend_20081217.pdf.

[135] Congress Plans, supra note 7 (quoting Columbia Law Professor John C. Coffee, Jr.). Bernard Madoff was a powerful and influential member of the securities industry since the 1960s. "He was board chairman of the Nasdaq Stock Market; was on the board of governors of the NASD; sat on an advisory committee for the Securities and Exchange Commission; and was chairman of the trading committee of Sifma, formerly the Securities Industry Association." Susan Antilla, Madoff's Country Clubbers Smiled $50 Billion Ago, Bloomberg.com, Dec. 15, 2008, http://www.bloomberg.com/apps/news?pid=email_en&refer==columnist_antilla&sid==ajTlcTh7XnYA.

[136] Congress Plans, supra note 7 (quoting Fordham Law Professor Steven Thel).

[137] Sec. & Exch. Comm'n, Office of Inspector Gen., Case No. OIG-483, Failure to Vigorously Enforce Action Against W. Holding and Bear Stearns at the Miami Regional Office 2–3, 13–14, 17–21 (Sept. 30, 2008), available at

that the failure to value mortgage-related securities properly eventually led to Bear Stearns's demise. Despite the firm's willingness to pay a $500,000 penalty for failure to supervise certain employees, the SEC staff abruptly dropped the investigation without even presenting the matter to the Commissioners.[138]

Kotz also released a report criticizing an SEC investigation of possible insider trading at Pequot Capital Management, a hedge fund.[139] The report recommended that three SEC officials be disciplined in connection with their handling of the investigation and accused the officials of, among other things, improperly disclosing details of the investigation to John Mack, then-CEO of Morgan Stanley.[140] The concerns in the report were seconded by members of Congress. On October 21, 2008, Senator Charles Grassley wrote to Chairman Cox asking him to investigate new allegations of favoritism and misconduct by senior SEC enforcement division officials.[141] The SEC responded to the call for disciplinary action by referring the matter to an SEC administrative law judge, who reviewed the records of the investigation and determined that they did not justify sanctioning the SEC officials involved.[142] The matter has not been laid to rest, however. According to the *New York Times*, the administrative law judge did not review the report in an official capacity, but rather in an individual capacity, responding to a request by the SEC's executive director.[143] Furthermore, new evidence has surfaced that Pequot Capital Management began making secret payments to a key witness in the case just after members

http://media.miamiherald.com/smedia/2008/10/14/20/Report_of_Investigation.source.prod_affiliate.56.pdf [hereinafter Bear Stearns Report].

[138] Id. at 4; Kara Scannell, SEC Watchdog Faults Agency in a Bear Case, Wall St. J., Oct. 11–12, 2008, at B6.

[139] Aguirre Report, supra note 5, at 15–16, 188–99.

[140] Id. at 187–91.

[141] Letter from Charles E. Grassley, Ranking Member, S. Comm. on Fin., to Christopher Cox, Chairman, Sec. & Exch. Comm'n (Oct. 21, 2008), available at http://finance.senate.gov/press/Gpress/2008/prg102108.pdf.

[142] Walt Bogdanich, S.E.C. Judge Finds Agency Didn't Mishandle Hedge Fund Inquiry, N.Y. Times, Nov. 11, 2008, at B3; see also Neil Roland, Judge's Ruling Settles SEC Leak Squabble, Fin. Wk., Nov. 16, 2008, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20081116/REG/311179978/1039/TOC (describing SEC review of allegations).

[143] Bogdanich, supra note 142, at B3.

of the Senate requested further investigation by the SEC.[144] In response to this new evidence, the SEC reopened the investigation.[145]

The details of the SEC's investigations and the underlying conduct at issue in these cases continue to be uncovered, and it is too early to condemn the agency's actions. Yet, at the moment, one significant question is the extent to which major frauds like Madoff's remain in existence, undetected or unaddressed by the SEC and its staff. The market's confidence has been shaken, not just by revelations of fraud, but by uncertainty about the extent of fraud that remains undetected and by concerns that the "top cop" has been asleep at the switch.

A final area of concern is the SEC's oversight of the credit rating agencies. Many commentators have criticized the rating agencies for their role in evaluating the complex mortgage-backed instruments that led to the credit crisis, although those criticisms are too extensive to detail here.[146] Whether the rating agencies engaged in self-dealing or were simply incompetent, there is little question that they failed to investigate the securities thoroughly and issued ratings that were, at best, highly inflated. The rating agencies are subject to SEC oversight under the Credit Agency Reform Act of 2006,[147] which was adopted in response to the rating agencies' failure to downgrade Enron until four days before it declared bank-

[144] Amit R. Paley, New Evidence Emerges in Closed Insider-Trading Case, Wash. Post, Dec. 12, 2008, at D1.

[145] Kara Scannell, SEC Reopens Probe of Trading at Pequot, Wall St. J., Jan. 7, 2009, http://online.wsj.com/article/SB123138635480363647.html?mod=todays_europe_money_and_investing. The SEC's Director of Enforcement subsequently resigned. See Gretchen Morgenson, Top Enforcer at the S.E.C. Steps Down, N.Y. Times, Feb. 9, 2009, http://www.nytimes.com/2009/02/10/business/10sec.html?ref=business (reporting resignation of Linda Chatman Thomsen amid criticisms of the Enforcement Division's performance).

[146] See, e.g., President's Working Group on Fin. Mkts., Policy Statement on Financial Market Developments 1 (Mar. 2008), available at http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf (identifying flaws in credit rating agency assessments of subprime mortgage-backed securities and other structured products as one of the "principal underlying causes of the turmoil in financial markets"); Technical Comm. of the Int'l Org. of Sec. Comm'ns, Consultation Report: The Role of Credit Rating Agencies in Structured Finance Markets 2 (Mar. 2008), available at http://www.tsi-gmbh.de/fileadmin/tsi_downloads/ABS_Research/Materialien_zur_aktuellen_Finanzmarktdebatte/IOSCO-Ratingagenturen.pdf ("CRAs and their ratings played a critical role in the recent market turmoil.").

[147] Credit Rating Agency Reform Act of 2006, Pub. L. No. 109-291, 120 Stat. 1327.

ruptcy.[148] Under rules adopted by the SEC in September 2007, rating agencies are required to register with the SEC as nationally recognized statistical rating organizations ("NRSRO")[149] and to comply with various SEC disclosure and policy rules.[150] The NRSRO designation has significant consequences in terms of the market for the agencies' ratings: many institutional investors may legally invest only in instruments that receive certain NRSRO ratings.[151]

Although the SEC's oversight of the credit rating agencies did not begin until relatively late in the subprime saga, it responded to its regulatory mandate by conducting a ten-month examination of the rating agencies that concluded in July 2008. At this point, the SEC issued a scathing, albeit redacted, report criticizing the agencies for conflicts of interest, poor internal auditing, and noncompliance with disclosure requirements.[152] The report documented e-mail correspondence revealing widespread disregard for the risks of the instruments that were being rated. As the *Wall Street Journal* reported after reviewing an unredacted version of the report, analysts at Standard & Poor's viewed it as their job to give a rating to every deal, no matter how bad.[153] Seemingly, however, like Mad-

[148] For a description of rating agency failures with respect to Enron, see Claire A. Hill, Rating Agencies Behaving Badly: The Case of Enron, 35 Conn. L. Rev. 1145, 1149 (2003).

[149] As of September 2008, there were ten NRSROs. See Sec. & Exch. Comm'n, Credit Rating Agencies—NRSROs (Sept. 25, 2008), http://www.sec.gov/answers/nrsro.htm, last updated Sept. 25, 2008. The three largest—Moody's, Standard & Poor's, and Fitch—have a market share of over 95%. Sec. & Exch. Comm'n, Annual Report on Nationally Recognized Statistical Rating Organizations: As Required by Section 6 of the Credit Rating Agency Reform Act of 2006, 35 (June 2008), available at http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf.

[150] Nationally Recognized Statistical Rating Organizations, 17 C.F.R. § 240.17g-1 to -6 (2008).

[151] See, e.g., John P. Hunt, The SEC's Proposed Rating Agency Rules: Unresolved Conflicts 1 (June 28, 2008), available at http://ssrn.com/abstract=1284709 (describing the importance of rating by NRSRO).

[152] Marie Leone, Subprime Slam: SEC Exposes Rating Agency Faults, CFO.com, July 8, 2008, http://www.cfo.com/article.cfm/11699984 ("In its report following a 10-month probe—citing several damning E-mails—the regulator says rating agencies suffer from conflicts of interest, deficient internal auditing, and poor disclosure policies.").

[153] Aaron Lucchetti, S&P Email: "We Should Not Be Rating It," Wall St. J., Aug. 2–3, 2008, at B1 (reporting an internal Standard & Poor's e-mail stating that a deal "could be structured by cows and we would rate it").

off's actions, none of these problems was deemed sufficiently serious to warrant enforcement action. To date, the SEC does not appear to have filed any enforcement actions against the credit rating agencies or their employees.[154]

The SEC did adopt new rules to address the problems identified in its report. The rules require greater disclosure by the rating agencies of both conflicts of interest and the performance of the bonds they rate.[155] Commentators have reacted negatively to the rules, however, stating that they will do little to address conflicts of interest.[156] Notably, the SEC failed to adopt the two most significant reforms under consideration: a rule that would have created different ratings for bonds and for structured products, and a rule that would have reduced reliance upon the ratings by mutual funds and other institutions.[157]

III. IMPLICATIONS OF THIS ANALYSIS

It is easy with the benefit of hindsight to find fault with many of the SEC's recent actions. The Blueprint identified regulatory consolidation and deregulation as the means to enhance the United States' ability to attract capital, investment banking business, and financial services in the wake of increasing global competitiveness. The subsequent market turmoil and continued revelation of scandals and market failures suggest that deregulation and consolidation may not be the best way to enhance U.S. competitiveness. Indeed, the credit crisis and the preceding discussion suggest that recent regulatory failures were precipitated by a lack of enforcement and financial transparency. Investment, governance, and operational decisions were all tainted by the inability of decision-

[154] The Attorney General for the State of Connecticut, one of the state regulators that the Blueprint is seeking to preempt, is investigating the rating agencies for antitrust violations. Alan Rappeport, Connecticut Goes After Ratings Agencies, CFO.com, Oct. 26, 2007, http://www.cfo.com/article.cfm/10047962.

[155] Press Release, Sec. & Exch. Comm'n, SEC Approves Measures to Strengthen Oversight of Credit Rating Agencies (Dec. 3, 2008), http://www.sec.gov/news/press/2008/2008-284.htm.

[156] Neil Roland, SEC's Long-Anticipated Crackdown on Bond Raters a Dud, Say Critics, Fin. Wk., Dec. 5, 2008, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20081205/REG/812059957.

[157] Id.

makers to evaluate complex financial transactions.[158] At its core, market discipline is impeded by the inability of market actors to evaluate the financial status and performance of public companies.

The SEC has gradually reduced its emphasis on transparency.[159] In part, the move appears to reflect a perception that market developments have reduced the need for mandated disclosure. Mandatory disclosure is costly, we are told, and institutional investors can protect themselves by contract.[160] The SEC responded by expanding the exemptions from traditional disclosure requirements that are available for financial products sold to sophisticated investors.[161] SEC Rule 144A is an example of this type of exemption,[162] as is the deregulation of over-the-counter derivatives described in Part II above.[163]

[158] The relationship of financial transparency to governance decisions was first identified by Louis Lowenstein. Louis Lowenstein, Essay, Financial Transparency and Corporate Governance: You Manage What You Measure, 96 Colum. L. Rev. 1335, 1342–45 (1996).

[159] See Brian G. Cartwright, Gen. Counsel, Sec. & Exch. Comm'n, Speech by SEC Staff: The Future of Securities Regulation (Oct. 24, 2007), available at http://www.sec.gov/news/speech/2007/spch102407bgc.htm (describing growth of institution-only markets and asset classes that do not involve disclosure or regulatory oversight other than anti-fraud remedies).

[160] See, e.g., Steven M. Davidoff, Paradigm Shift: Federal Securities Regulation in the New Millennium, 2 Brook. J. Corp. Fin. & Com. L. 339, 352 (2008) (explaining that institutionalization creates an opportunity for deregulation in which the unnecessary transaction costs of compliance with the federal securities laws can be replaced with private bargaining); Troy A. Paredes, On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission, 2006 U. Ill. L. Rev. 975, 991 (2006) (stating that "the notion that investors who can 'fend for themselves' do not need SEC protection is an animating principle of securities regulation that helps demarcate the appropriate boundary of SEC regulation across the federal securities laws").

[161] Retail investors are told to protect themselves by diversifying, by investing through skilled intermediaries, or perhaps by staying out of the market altogether. See, e.g., Stephen Choi, Regulating Investors Not Issuers: A Market-Based Proposal, 88 Cal. L. Rev. 279, 310 (2000) (proposing a requirement that investors be licensed before being allowed to engage in securities transactions); Felix Salmon, Stop Selling Bonds to Retail Investors, 35 Geo. J. Int'l L. 837 (2004) (arguing that retail investors should not be permitted to invest in sovereign bonds).

[162] See Langevoort, supra note 25, at 28–30 (describing the development of the Rule 144A market).

[163] See Jerry W. Markham, Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?, 12 Yale J. on Reg. 345, 354–55 (1995) (summarizing deregulatory responses to demands of institutional investors).

Whether these decisions reflect agency capture or simply misjudgment, recent events suggest that even sophisticated institutional investors require greater regulatory protection. The largest investment banks failed both to assess the risks of their collateralized debt obligation ("CDO") investments properly and to manage those risks through hedging or diversification. The investors in Madoff's Ponzi scheme included hedge funds, wealthy individuals, and large institutional investors. Professor Calomiris suggests that pension fund investors actually fueled the decline in ratings quality by knowingly demanding overpriced securities.[164] These failures are passed through to the institutional intermediaries' beneficial owners.

The credit crisis is likely to result in an increased emphasis on transparency and enforcement, at least in the short term.[165] This emphasis is perhaps the strongest argument for retaining the SEC in one form or another. Whatever its flaws, the SEC's expertise in mandating and enforcing disclosure gives it an advantage over alternative regulators. By way of comparison, for example, the Federal Reserve[166] had direct statutory authority to protect mortgage customers under the Truth in Lending Act,[167] yet its disclosure

[164] Charles W. Calomiris, The Subprime Turmoil: What's Old, What's New, and What's Next 27–28 (Oct. 2, 2008) (unpublished manuscript, available at http://www.aei.org/docLib/20081002_TheSubprimeTurmoil.pdf) ("I doubt that rating agencies were deceiving sophisticated institutional investors about the risks of the products they were rating; rather they were transparently understating risk and inflating the grading scale of their debt ratings for securitized products so that institutional investors (who are constrained by various regulations to invest in debts rated highly by NRSROs) would be able to invest as they liked without being bound by the constraints of regulation or the best interests of their clients.").

[165] See, e.g., Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, Address to Practising Law Institute's "SEC Speaks in 2009" Program (Feb. 6, 2009), available at http://www.sec.gov/news/speech/2009/spch020609mls.htm (announcement by newly appointed SEC Chairman Mary Schapiro of renewed emphasis on enforcement). Professor Fox suggests that an additional justification for improving transparency is that it is likely to improve corporate governance and lead to better operational decisions. Merritt B. Fox, Civil Liability and Mandatory Disclosure, 109 Colum. L. Rev. (forthcoming 2009) (manuscript at 16–19, available at http://ssrn.com/abstract=1115361).

[166] Professors Coffee and Sale argue that the Federal Reserve is superior to the SEC, at least with respect to prudential financial regulation. Coffee & Sale, supra note 1, at 775–78.

[167] 15 U.S.C. § 1601(a) (2006) (establishing statutory goal of customer protection); Patricia A. McCoy, Rethinking Disclosure in a World of Risk-Based Pricing, 44 Harv.

mandates were laughable when analyzed according to the SEC's concededly imperfect disclosure standards.[168] The Federal Reserve had broad authority under the Federal Trade Commission Improvements Act to prevent unfair and deceptive acts and practices in the mortgage industry,[169] yet it failed to use this authority to safeguard investors from the distorted incentives and conflicts of interest of mortgage brokers.[170] Similarly, until quite recently, the Federal Reserve allowed credit card issuers to engage in a variety of unfair and deceptive practices, relying exclusively on disclosure requirements that have been heavily criticized.[171]

Likewise, commentators have criticized the CFTC for its limited efforts regarding enforcement and investor protection. A CFTC internal review in 1994 "raised major questions about CFTC's ability to adequately perform its enforcement mission."[172] Former CFTC Chair (now SEC Chair) Mary Schapiro conceded in a 2005 interview that the CFTC is less focused on investor protection than the SEC, relying primarily on market mechanisms for regulating be-

J. on Legis. 123, 148 (2007) (describing the Federal Reserve's authority, under current law, to mandate improved disclosure).

[168] The Federal Reserve's disclosure requirements are contained in Regulation Z, 12 C.F.R. § 226 (2008). See Oren Bar-Gill & Elizabeth Warren, Making Credit Safer, 157 U. Pa. L. Rev. 1, 38–43 (2008) (describing how consumer mistakes in understanding terms of mortgage loans cost them "billions of dollars"); McCoy, supra note 167, at 123–24, 129–32 (describing inadequate disclosure requirements for mortgages, especially subprime mortgages).

[169] Federal Trade Commission Improvements Act of 1980, 15 U.S.C. §§ 57b-1 to -4 (2006).

[170] Bar-Gill & Warren, supra note 168, at 88–89 & n. 287 (describing the Federal Reserve's authority under the Federal Trade Commission Improvements Act).

[171] See, e.g., Nancy Trejos, Fed to Pursue Aggressive Checks on Credit Cards, Wash. Post, May 2, 2008, at A1 (describing proposed regulations to change the Federal Reserve's traditional policy of relying on disclosure with rules that would ban problematic practices and fees as "unfair or deceptive"); Associated Press, Feds Take Swipe At Credit Card Rules, CBS News, Dec. 18, 2008, http://www.cbsnews.com/stories/2008/12/18/business/main4675174.shtml (describing Federal Reserve adoption of new rules governing late fees, double-cycle billing, interest rate increases, and other credit card practices).

[172] Markets and Trading Reorganization and Reform Act of 1995: Hearing on H.R. 718 Before the Subcomm. on Capital Markets, Securities, and Government Sponsored Enterprises of the H. Comm. on Banking & Financial Services, 104th Cong. 3 (1995) (statement of James Bothwell, Director, Financial Institutions and Markets Issues General Government Division, General Accounting Office).

havior.[173] And CFTC rules have provided far less investor protection than those of the SEC.[174]

If we retain the SEC, can it be made more effective? A comprehensive treatment is beyond the scope of this article, but this section will suggest three measures that may provide at least a start. The first recommendation is greater oversight of financial intermediaries. Financial intermediaries—from investment advisors, to broker-dealers, to mutual funds—participate in the vast majority of financial transactions.[175] They play a critical role in controlling the investments of an ever-increasing percentage of retail investors. Through their investment decisions and recommendations, they also control the cost of capital for public issuers.

Financial intermediaries present several regulatory challenges. Perhaps the most significant is that they create additional levels of agency costs. Intermediaries, by definition, deal with other people's money. As such, they may lack adequate incentives to take appropriate levels of risk, to investigate thoroughly, or to disclose conflicts of interest. Compensation structures may increase agency costs by encouraging a short term perspective, rewarding excessive risk-taking, or incentivizing herding.

Many of the SEC's most glaring deficiencies—from Madoff to Bear Stearns to the NRSROs—have centered on intermediary oversight.[176] As indicated above, the SEC has freed institutional investors from many regulatory constraints with respect to their investment decisions. This freedom, in turn, makes it difficult to understand and value the assets held by institutions, which reduces the ability of beneficial owners to understand and evaluate their

[173] Orrick Client Alert, President-Elect Obama Names SEC and CFTC Chairmen and Fed Governor, Dec. 19, 2008, http://www.orrick.com/fileupload/1575.pdf (quoting 2005 interview with Mary Schapiro).

[174] See, e.g., Richard Carlucci, Note, Harmonizing U.S. Securities and Futures Regulations, 2 Brook. J. Corp. Fin. & Com. L. 461, 467–78 (2008) (describing differences between SEC and CFTC customer protection rules including suitability requirement, investment account protection, and prohibition of insider trading).

[175] Madoff, for example, was able to extend the scale of his fraud through the complicity of investment advisors who, rather than investing client funds themselves, simply gave Madoff those funds to invest—often without telling their clients.

[176] See also Barbara Black, Are Retail Investors Better off Today?, 2 Brook. J. Corp. Fin. & Com. L. 303, 306 (2008) (identifying particular damage to retail investors resulting from intermediary misconduct such as the research analyst scandal, mutual fund late trading, and broker-dealer conflicts of interest).

agents' investment decisions.[177] The resulting lack of discipline increases agency costs. The SEC has also delegated extensive oversight responsibility to the industry itself, despite the industry's limited incentives to regulate against its members' self interest. This delegation is particularly problematic with respect to enforcement in which the industry has a long history of condoning unsafe and unfair practices.[178] Going forward, it is critical that the SEC address, in a comprehensive manner, intermediary discipline, including the regulation, through disclosure or otherwise of fees, sales practices, and conflicts of interest.

Second, the SEC must improve its access to market data and developments. It must become more proactive in identifying trends, evaluating existing regulation and understanding new financial markets and products.[179] Rather than relying on high level staffers, who may be many years removed from the industries that they regulate, the SEC should use industry consultants—who are compensated at market rates—to bring their expertise to the agency. The SEC should make particular use of non-lawyer consultants including Wall Street traders, economists and buy-side investors.[180] Similarly, the SEC should exercise its supervisory powers to collect more extensive data on regulatory issues—ranging from the effectiveness of FINRA's broker-dealer oversight to the allocation of

[177] Beneficial owners are the ultimate source of the capital invested by institutional investors. See, e.g., Jeffrey N. Gordon, Commentary, Individual Responsibility for the Investment of Retirement Savings: A Cautionary View, 64 Brook. L. Rev. 1037, 1039 (1998) (explaining that "[i]nstitutional investors serve as financial intermediaries collecting capital from dispersed investors and in turn invest it in specific companies").

[178] Professors Coffee and Sale argue that shifting administration of net capital requirements to banking regulators would reduce the risk of regulatory capture. Coffee & Sale, supra note 1, at 775. Separating prudential financial regulation from regulating record-keeping, order processing, customer protection, and other operations may not be efficient, however, and it is unclear that the Federal Reserve has sufficient expertise and concern with investor protection to oversee these other aspects of investment banking regulation effectively.

[179] Professors Coffee and Sale observe that the SEC is poorly positioned to address derivatives regulation because of its lack of regulatory authority. Coffee & Sale, supra note 1, at 776. As indicated above, the SEC has already attempted to address the risk associated with derivatives trading by requiring increased disclosure of derivatives positions. See supra notes 123–126 and accompanying text. Moreover, in light of the role of derivatives in the credit crisis, legislation increasing the SEC's regulatory authority over derivatives is not just politically plausible, but likely.

[180] Use of such consultants would address Coffee & Sale's concern over the agency's lack of expertise. See Coffee & Sale, supra note 1, at 744.

settlement funds in private securities fraud litigation. The SEC could hire empirical scholars to evaluate this data, or alternatively, could make the data available for academic research under suitable conditions. This process would harness the private incentives of researchers and enable the SEC to evaluate the effectiveness of its regulatory policies.

Third, and perhaps most important, staffing at the SEC, including the appointment of SEC Commissioners, must reflect a renewed emphasis on leadership—leadership that entails a commitment to regulation.[181] Although this article does not condone excessive regulation or regulatory zeal, the nation's top cop should not be under the supervision of officials who espouse extensive deregulation.[182] Such a perspective creates a negative tone at the top, and may spawn situations like the Aguirre matter in which SEC staff fear that their superiors will punish investigative and enforcement efforts that are politically problematic or target influential Wall Street insiders.[183]

In this vein, future policymakers, including the President, should make a greater effort to include representation from the full range of constituencies over which the SEC exercises power. Recent staffing and appointments at the federal regulatory agencies have

[181] See, e.g., R. Edward Freeman, Jeffrey S. Harrison & Andrew C. Wicks, Managing for Stakeholders: Survival, Reputation, and Success 17 (2007) (describing importance of "tone at the top" in connecting leadership and ethics). For a detailed analysis of what leadership entails, including the creation of a vision for the future and a system for identifying and responding to breakdowns, see Allan L. Scherr & Michael C. Jensen, A New Model of Leadership 32–33 (Harvard NOM Working Paper No. 06-10, 2007), available at http://ssrn.com/abstract=920623. The various Inspector General reports, and the SEC's response to those reports, suggest a critical absence of these functions.

[182] As this article goes to press, the extent to which President Obama's appointment of Mary Schapiro reflects a change in leadership policy remains unclear. Compare Randall Smith, Tom McGinty & Kara Scannell, Obama's Pick to Head SEC Has Record of Being a Regulator with a Light Touch, Wall St. J., Jan. 15, 2009, http://online.wsj.com/article/SB123194123553080959.html (criticizing Schapiro for failing to pursue "tough action against big Wall Street firms"), with Stephen Labaton, S.E.C. Nominee Offers Plan for Tighter Regulation, N.Y. Times, Jan. 16, 2009, at B3 (describing Schapiro's proposals for greater regulation of hedge funds and credit rating agencies).

[183] See, e.g., Jesse Westbrook, Cox Quits at SEC, Leaves Schapiro to Restore Clout, Bloomberg.com, Jan. 21, 2009, http://www.bloomberg.com/apps/news?pid=email_en&refer=&sid=aJuH2AuRdpnA (quoting Columbia Law Professor Harvey Goldschmid as criticizing lack of leadership and morale problems).

reflected a strong bias in favor of lawyers (at the SEC)[184] and officials with sell-side expertise (at Treasury).[185] In addition to the potential for skewing regulatory policy, the lack of diversity may cause the SEC to succumb to similar biases as those of the constituencies that it regulates.[186] In essence, this recommendation suggests that the President in appointing, and Congress in confirming, SEC commissioners should be sensitive not only to political but also to institutional perspectives and attempt to incorporate a sufficient range of viewpoints to allow the agency to operate independently of Wall Street financial firms, corporate issuers, and other influential market participants.

CONCLUSION

The credit crisis and other recent scandals have exposed widespread regulatory failures that offer little cause for celebrating the current regulatory structure. Coffee and Sale provide a detailed analysis of the CSE program, concluding from its failure that the SEC is ill-suited to regulate the major investment banks. Their conclusion seems to be borne out by those banks' migration to oversight by the Federal Reserve.

An eventual economic turnaround is likely to spawn the growth of new investment banks which, along with hedge funds, private equity, investment advisers and the like, will challenge the parameters of the current regulatory structure. Historically, our system has drawn regulatory boundaries in terms of institution and product type rather than regulatory mission. An increased emphasis on defining the appropriate regulatory objectives and designing an appropriate structure to address those objectives is a critical component of any substantial regulatory reform.

[184] See, e.g., Harold Bradley, Whack-a-mole: The Story of Goldman Sachs and The U.S. Economy, KansasCity.com, Jan. 9, 2009, http://economy.kansascity.com/?q=node/776 (arguing that government leaders do not understand the financial markets: "Most SEC chiefs are lawyers; they've never made a trade in their lives").

[185] See id. (describing review of 100 resumes posted on Treasury department website showing that only one official came from an investor's background and the other 99 came from the "sellside").

[186] For a more detailed analysis of the potential for regulator bias and irrationality at the SEC, see Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 Stan. L. Rev. 1, 6, 44, 56 (2003).

The continued role of the SEC in the future of financial regulation remains unclear. This article argues that, although the precise form of regulatory reform is not critical, the reform efforts must emphasize transparency and enforcement. Despite the SEC's recent shortcomings, its history as Wall Street's most effective enforcer, coupled with its expertise at designing and enforcing disclosure requirements, make it the most plausible candidate for the job. Increased intermediary oversight, a more vigorous and formalized program of obtaining and analyzing market data and developments, and a renewed emphasis on effective leadership will enable the agency to function more effectively. With these modest improvements, the SEC may still be able to dance at its 100th birthday.