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Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan

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SUPER REGULATOR: A COMPARATIVE ANALYSIS OF SECURITIES AND DERIVATIVES REGULATION IN THE UNITED STATES, THE UNITED KINGDOM, AND JAPAN

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I. INTRODUCTION

The value of competition among regulators has been the subject of debate in the United States ("U.S.") for some time.[1] On the one hand, its advocates contend that competing regulatory bodies will not only govern less, but also more efficiently.[2] Proponents of centralized regulation, on the other hand, argue that overlapping regulation is costly, inefficient, and allows exploitation and abuses along regulatory seams.[3] In supporting their arguments, however, both sides of this debate rely largely on intuitive arguments or anecdotal evidence. This is due to a lack of regulatory models that would provide a more substantive measure of the efficacy of a monolithic regulator over that of a more dispersed and competitive regulatory system. The Financial Services Authority in the United Kingdom

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1. *See generally* BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 8 (1984) [hereinafter BLUEPRINT FOR REFORM] (study considering effects of multiple regulators). The concept of competitive regulation is often referred to as "functional" regulation. *See, e.g.*, Melanie L. Fein, *Functional Regulation: A Concept for Glass-Steagall Reform*, 2 STAN. J. L. BUS. & FIN. 89, 90 (1995) ("According to its history, functional regulation seeks to promote competitive equality, regulatory efficiency, and investor/consumer protection.").

2. *See generally* Jonathan R. Macy, *The Business of Banking: Before and After Gramm-Leach-Bliley*, 25 J. CORP. L. 691, 713 (2000) (discussing why regulatory competition can be beneficial).

3. *See generally* Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441, 459 (1998) (arguing for regulation of risk rather than function); Bert Ely, *Functional Regulation Flunks: It Disregards Category Blurring,* AMER. BANKER, Feb. 21, 1997, at 4 (criticizing competitive regulation).

("FSA-UK") and the Financial Services Agency in Japan ("FSA-Japan") are two agencies of recent vintage with a unified regulatory structure that should provide a basis of comparison with the competitive regulatory approaches of the U.S.

Part II of this Article first describes the development of competing U.S. regulatory bodies for banking, insurance, securities, and derivatives. Part III focuses on the regulatory roles of the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") and Part IV describes the competition between these two agencies and its effects. Part V discusses the changes within the structure of the financial markets that affected the regulatory climate. After that review, Parts VI and VII examine the roles of the FSA-UK and FSA-Japan. Finally, Part VIII discusses the arguments for and against competitive regulation and attempts to discern whether a unified regulatory structure such as those in Japan and the United Kingdom ("U.K.") is preferable to the competitive approach of the SEC and CFTC.

II. FUNCTIONAL OR COMPETITIVE REGULATION IN THE U.S.

A. Banking

While the regulation of the financial services industry has been widely dispersed among a number of regulators, this decentralization is a reflection of history rather than design. Banking regulation is illustrative.[4] The federal government exercised an indirect role in the regulation of banking through the First and Second Banks of the U.S., until President Andrew Jackson crushed that institution in the fight over the renewal of its charter,[5] leaving a regulatory vacuum that the states filled with their own banking commissions.[6]

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4. *See generally* Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221 (2000) [hereinafter Markham, *Banking Regulation: Its History and Future*].

5. *See generally* CLAUDE G. BOWERS, THE PARTY BATTLES OF THE JACKSON PERIOD 222–26 (1922) (describing this political battle between Andrew Jackson and Henry Clay); ROBERT V. REMINI, HENRY CLAY: STATESMAN FOR THE UNION 397-99 (1991) (same).

6. The states had already imposed some regulatory requirements on banks, but the "bank mania" that followed the destruction of the Bank of the U.S. and the Panic of 1837, which was also precipitated by Jackson, led to the

The Civil War and the disarray of the nation's currency led to the introduction of federal bank regulation that established the national banks and gave regulatory authority over these institutions to the Comptroller of the Currency.[7] This created a "dual" system of banking regulation — state and federal — which is said to have:

> [F]ostered what is probably the greatest mass of redundant, otiose, and conflicting monetary legislation and the most complex structure of self-neutralizing regulatory powers enjoyed by any prominent country anywhere. It has put the federal government and the states in competition for the number and size of banks under their respective jurisdictions . . . .[8]

The creation of the Federal Reserve Board in the wake of the Panic of 1907[9] and the Federal Deposit Insurance Corporation ("FDIC") after widespread banking failures at the outset of the Great Depression in the 1930s,[10] added further layers to this regulatory competition. If that were not enough, Congress and the states also provided separate regulation for savings banks[11] and credit unions.[12]

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creation of more formal banking commissions or departments. Markham, *Banking Regulation: Its History and Future, supra* note 4, at 226–27.

7. National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified as amended in scattered sections of 12 U.S.C.).

8. BRAY HAMMOND, SOVEREIGNTY AND AN EMPTY PURSE: BANKS AND POLITICS IN THE CIVIL WAR 349–50 (1970).

9. *See generally* 1–2 PAUL M. WARBURG, THE FEDERAL RESERVE: ITS ORIGIN AND GROWTH (1930).

10. Banking Act of 1933, ch. 89, 48 Stat. 162, 168–69. One in four banks in the U.S. failed during the bank panic. *The Bubble Burst*, LIFE, Spring 1992, at 26.

11. States had overseen the operations of building and loan societies and savings banks since their appearance early in the nineteenth century. Federal charters for savings banks were not available until 1978. LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 79–81, 87 (2001). The Federal Home Loan Bank Act of 1932 created the Federal Home Loan Bank Board to charter and supervise federal savings and loan associations. Federal Home Loan Bank Act, Pub. L. No. 107-252, 47 Stat. 725 (1932) (codified as amended at 12 U.S.C. § 1421 (2000)). Federal insurance for these institutions was created by the National Housing Act 1934, ch. 847, 48 Stat. 1246 (codified as amended at 12 U.S.C. § 1724 (2000)), *repealed* by Act of Aug. 9, 1989, Pub. L. No. 101-73, tit. IV, § 407, 103 Stat. 363.

12. Federal Credit Union Act, Pub. L. No. 107-252, 48 Stat. 1216 (1934) (codified as amended at 12 U.S.C. § 1759 (2000)), authorized national charters

The Great Depression had even broader effects in fostering the balkanization of regulation in financial services. The activities of banks were already limited in scope by statute,[13] but the Glass-Steagall Act sought to further seal off banking from other financial service businesses by prohibiting banks from dealing in investment banking activities.[14] No justification has ever been shown for this prohibition,[15] and Senator Glass himself unsuccessfully sought its repeal one year after adoption.[16] Nev-

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for credit unions. *See* Nat'l Credit Union Admin. v. First Nat'l Bank & Trust Co., 522 U.S. 479, 479–85 (1998) (describing scope of Federal Credit Union Act). Most states already had legislation regulating such entities after President William Howard Taft wrote to the states in 1908, asking them to enact authorizing legislation for credit unions. BROOME & MARKHAM, *supra* note 11, at 89.

13. Traditionally, banks had no power to engage in commercial and real estate transactions, except to secure a debt or as an accommodation to a customer. 1 CARL ZOLLMANN, THE LAW OF BANKS AND BANKING §§ 223, 224 (1936). *See also* Jemison v. Citizens Savings Bank of Jefferson, 25 N.E. 264 (N.Y. Ct. App. 1890) (bank could not deal in cotton futures as either principal or agent). The National Bank Act of 1864 also limited national bank activities in a similar fashion. *See generally* First Nat'l Bank of Charlotte v. National Exchange Bank of Baltimore, 92 U.S. 122 (1875) (discussing limitations on the operations of national banks). The Bank Holding Company Act of 1956 sought to further circumscribe the activities of banks by limiting the operations of entities within a bank holding company structure to "activities so closely related to banking or managing or controlling banks as to be a proper incident thereto." Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. § 1843(c)(8) (2000)).

14. The Glass-Steagall Act was a part of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). *See* Securities Industry Assoc. v. Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988) (describing provisions of the Glass-Steagall Act).

15. The Glass-Steagall Act was concerned principally with the operations of the securities affiliates operated by several large banks, the most important of which was the First National City Co. affiliated with the National City Bank (now Citigroup). The affiliates had been created despite a ruling from the Solicitor General of the U.S. that such operations were not permitted by the National Bank Act. 2 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTOR (1900–1970), at 57–58 (2002) [hereinafter 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S.]. A study of some 3,000 national bank failures before 1936 found that bank securities activities were low on the list of factors that resulted in bank insolvencies. A representative from the Federal Reserve Board also testified during the hearings on the Glass-Steagall legislation that such a prohibition was unnecessary. *Id.* at 168.

16. *Id.* at 371.

ertheless, the legislation remained the "'Maginot Line' of the financial world,"[17] excluding banks from many of the financial activities of broker-dealers until its repeal in 1999 by the Gramm-Leach-Bliley Act ("GLBA").[18]

B. Insurance

Another sector of the financial services industry is insurance. It too owes its competing regulatory structure to history. The states had gradually imposed regulation on insurance companies to prevent abuses and regarding the maintenance of resources adequate to meet claims.[19] A scandal in the insurance industry at the beginning of the twentieth century resulted in an investigation by a legislative committee of the New York legislature.[20] Headed by State Senator William Armstrong, the investigation uncovered several abuses resulting in legislation that, among other things, barred the insurance industry from underwriting and other securities activities, restricted its ability to invest in stocks, and separated insurance companies from the banking industry.[21] Since New York was then the center of insurance, its lead was followed by other states.

Thereafter, the doctrine of unexpected consequences came into play. Sealed off from the securities industry, the insurance companies could not participate in the market excesses of the 1920s and thus avoided the devastation visited on investors fol-

17. Bevis Longstreth, *Current Issues Facing the Securities Industry and the SEC*, Address Before the Securities Industry Association, May 4, 1982, *quoted in*, Jonathan Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, 5 (1984).

18. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 and 15 U.S.C.).

19. Massachusetts regulated its insurance companies in 1837 and New York in 1851. Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 IOWA J. CORP. L. 723, 728 (2000).

20. *Id.* at 730. The Committee was formed after news reports that James Hyde, a twenty-three year old heir who had assumed control of the Equitable Life Assurance Co. in New York, had thrown a $100,000 party at Sherry's restaurant. *Id.* Concern was expressed that Hyde was looting the insurance company to fund his extravagant life style. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 18–20. Among the attendees at the party at Sherry's was Franklin D. Roosevelt. DENIS BRIAN, PULITZER: A LIFE 299 (2001).

21. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 18–20.

lowing the Stock Market Crash of 1929. The insurance companies also escaped the massive failures in the banking sector and thus eluded the scrutiny of President Roosevelt and Congress in the New Deal legislation regulating banking and commodity futures. But this escape was a narrow one — the Temporary National Economic Committee ("TNEC") rejected an SEC proposal to create a federal agency to regulate insurance companies only after vigorous opposition from the industry.[22]

The next federal regulatory threat came from the Supreme Court's decision in *United States v. South-Eastern Underwriters Association*,[23] which held that the insurance industry was subject to the federal antitrust laws. There was fear that this would impair the ability of insurance companies to pool statistics and preempt state regulation. Receptive to such concerns, Congress then passed the McCarran-Ferguson Act,[24] which granted insurance companies immunity from the antitrust laws to the extent that they were regulated by state insurance laws.

The McCarran-Ferguson Act largely excluded any federal regulation until insurance companies began offering variable annuities in 1952.[25] The SEC claimed that variable annuities were securities subject to regulation under the federal securities laws because returns were based on the investment of the annuitants' premium payments in securities. The Supreme

22. Another SEC proposal would have allowed federal agents to inspect insurance companies, but it too failed to be adopted. The SEC also wanted insurance companies, which were one of the largest sources of finance for large corporations, to invest in greater amounts of common stocks. Corporate balance sheets were becoming over-leveraged by debt sold to the insurance companies, and this concerned the TNEC, as well as the SEC. *Id.* at 245–50.

The insurance industry defeated these proposals by pointing out that avoiding stocks as an investment for insurance company reserves had saved the industry from disaster when the market collapsed in the wake of the Stock Market Crash of 1929. TNEC, *Investigation of Concentration of Economic Power*, Monograph No. 28A: Statement of Life Insurance, 76th Cong., 3d Sess. 4 (1941).

23. United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).

24. McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011–15 (2000)).

25. The variable annuity was the invention of the College Retirement Equities Fund ("CREF"), an affiliate of the Teachers Insurance and Annuity Association ("TIAA"). *See* CEDRIC V. FRICKE, THE VARIABLE ANNUITY: ITS IMPACT ON THE SAVINGS-INVESTMENT MARKET 2 (1959).

Court found for the SEC in these cases,[26] resulting in dual regulation of insurance companies selling variable contracts, as they were required to separate reserves for such products from reserves for more traditional insurance.[27]

Despite some frightening losses in the late 1980s that led to calls for federal regulation, the insurance industry was able to avoid most other federal intrusions.[28] What the industry could not avoid, however, was competition from the banking and securities industries. This was because the variable annuity was a product that was sold by stockbrokers, who did so in large numbers.[29] Federal bank regulators also opened the door for banks to sell insurance products in the 1990s.[30] This resulted in a restructuring of the insurance industry — insurance companies demutalized and expanded their own financial service offerings.[31]

C. Securities

Further separation of financial services into distinct sectors came through the adoption of legislation to regulate the securities industry during the Great Depression. The SEC's history and background is well-known[32] — it was a product of the Stock Market Crash of 1929 and the subsequent depression.[33] The

26. SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959).

27. Broome & Markham, *supra* note 19, at 737.

28. *See id.*

29. *See id*. at 743 (describing broker-dealer competition).

30. The banks used a statute that many thought had been repealed to gain entry into the insurance industry. *See* U.S. Nat'l Bank of Oregon v. Indep. Agents of Am., 508 U.S. 439 (1993). *See also* Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25 (1996) (states unable to restrict banks from selling insurance).

31. Broome & Markham, *supra* note 19, at 745–46.

32. For the uninitiated, see generally JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (1995).

33. The causes of the Stock Market Crash of 1929 are still widely debated. Blame is attributed to, *inter alia,* excessive speculation through margin accounts and abusive market practices, such as the organized pools that operated in over one hundred NYSE stocks in the 1920s. More recent focus has centered on the blunders of the Federal Reserve System, which first eased credit in order to support England's effort to return to the gold standard, thereby boosting the market. The Federal Reserve then reversed course and sought to curb the market through ill-conceived interest rate increases, an

SEC, which was ultimately given regulatory authority over the statutes that now comprise the federal securities laws, operates on a principle of full disclosure.[34] In adopting this legislation, Congress did not preempt the regulation of sales of securities under state blue-sky laws, thereby creating a competing layer of governmental regulation that was not lessened until late in the twentieth century.[35] Aside from some tinkering principally de-

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echo of recent events. There is also the possibility that the market was simply over-heated and needed correction. *See* 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 143–45, 150–53. Similar controversy exists over what caused and prolonged the Great Depression. Some claim that the market crash itself caused the depression — *post hoc, ergo propter hoc*. Indeed, recessions and depressions often follow a market crash, but that may suggest no more than that the market anticipates the economic decline. Today, most economists seem to agree that the Stock Market Crash of 1929 was not the cause of the Great Depression or its impressive duration. *See generally* Marco A. Espinosa-Vega & Jang-Ting Guo, *On Business Cycles and Countercyclical Policies; Statistical Data Included*, 86 ECON. REV. 1 (2001) (discussing economic theories on causes of the Great Depression). One author has even stated that the Stock Market Crash of 1929 "was probably an event of relatively minor significance" in causing the Great Depression. CHARLES R. MORRIS, MONEY, GREED, AND RISK: WHY FINANCIAL CRISES AND CRASHES HAPPEN 73 (1999). *See also The Crash of 1929 — A New View*, WALL ST. J., Oct. 28, 1977, at 16 (blaming tariff increases and increases in income tax).

34. The statutes administered by the SEC are the Securities Act of 1933, 15 U.S.C. § 77a–77bbbb (2000) (requiring full disclosure in connection with new offerings of securities to the public); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm (2000) (creating the SEC and requiring continual financial reporting by public companies, providing SEC regulatory control over proxy solicitations and tender offers, and regulating the secondary markets in publicly owned securities); the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79–79z-6 (2000) (simplifying the holding company structure of public utilities); the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-bbbb (2000) (regulating the administration of debentures issued under trust indentures); the Investment Company Act of 1940, 15 U.S.C. 80a-1 to 80a-64 (the world's most complex statute seeks to regulate investment companies, including mutual funds); and the Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2000) (regulating and registering investment advisors).

35. The National Securities Markets Improvement Act of 1996 preempted much state securities regulation or required the states to conform their standards to those of the SEC. The act exempted Nasdaq and exchange listed stocks from state regulation. Also exempted were investment companies and investment advisers with significant amounts of funds under management. State broker-dealer record-keeping, net capital, and other requirements regulating such entities were required to conform to those of the SEC. The SEC broadened its record-keeping requirements for broker-dealers to address the states' fear that such preemption would frustrate their regulation of broker-

signed to increase regulation, the federal securities laws remain more or less in the form arrived at in the 1930s.[36]

Another competing regulatory structure also remains — that of the self-regulatory organizations ("SROs"). These non-governmental organizations were given regulatory authority,

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dealers. *See generally* 23A JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 6.02 (2001) (describing SEC rule amendments).

36. Tinkering may be a bit of an understatement. For example, amendments were made in 1964 to strengthen financial reporting by public companies. 15 U.S.C. § 78m(a) (2000). *See generally* Richard Phillips & Morgan Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706. In 1968, the Williams Act began regulating tender offers and played an important role in the merger mania of the 1980s. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. § 78n(d)–(f) (2000)). For a description of the Williams Act, see Miriam P. Hechler, *Toward a More Balanced Treatment of Bidder and Target Shareholders*, 1997 COLUM. BUS. L. REV. 319. In 1970, after a "paperwork crisis" that resulted in the failure of numerous firms, Congress created the Securities Investor Protection Act ("SIPA") and the SIPA Corporation ("SIPC") that provides insurance for broker-dealer bankruptcies. 15 U.S.C. § 78aaa (2000). For a description of the problems that led to the paperwork crisis and the creation of SIPA, see SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, REPORT AND RECOMMENDATIONS, H.R. DOC. NO. 91-231 (1971). Legislation enacted in 1975 regulated clearing and settlement activities, imposed more stringent regulation over broker-dealer operations, established regulation over municipal bond dealers, and sought to create a national market system. For a description, see S. REP. NO. 94-75 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179; H.R. REP. NO. 94-123 (1975). Dealers in U.S. government securities were regulated after scandals involving unregistered "repo" dealers. Government Securities Act of 1986, Pub. L. No. 99-571, 100 Stat. 3208 (1986). For a description of the problems in the repo market, see H.R. REP. NO. 99-258 (1985); S. REP. NO. 99-426 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5395; *Regulating Government Securities Dealers: Hearing on H.R. 2032 Before Subcomm. On Telecomm., Consumer Prot., and Fin. of the House Comm. on Energy and Commerce,* 99th Cong. 201–13 (1985) (Report by John S. R. Shad, Chairman, Securities and Exchange Commission (June 20, 1985)). Insider trading sanctions were also strengthened after a series of scandals. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. § 78u(d) (2000)); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended at 15 U.S.C. §§ 78t-1, 78u-1 (2000)). For a description of those scandals, see DAVID A. VISE & STEVE COLL, EAGLE ON THE STREET (1991). Additional legislation was enacted to deal with penny stock fraud after a series of swindles. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified as amended at 15 U.S.C. 78q-2 (2000)).

and shelter from the antitrust laws,[37] by the Securities Exchange Act of 1934,[38] under which the exchanges, and later the National Association of Securities Dealers, Inc. ("NASD"),[39] are required to regulate the conduct of their members. The role of the SEC in this self-regulation is to oversee the exchanges, as well as to act directly where SRO oversight fails.[40] The SRO concept actually added several layers of regulators. In addition to the NASD and the New York Stock Exchange ("NYSE"), the SROs came to include the regional exchanges (e.g., the American Stock Exchange and the Philadelphia Stock Exchange) and the Chicago Board Options Exchange, Inc. ("CBOE"). The creation of the Municipal Securities Rulemaking Board added another element of self-regulation that gave rulemaking authority to this entity, but left enforcement with the SEC and bank regulators.[41]

Though the SROs generally attempt to coordinate their regulation in order to avoid duplication, there has been some competition among the SROs (such as the rivalry between the stock exchanges over options trading once it became clear that the CBOE would succeed).[42] The SEC initially sought to quash the

37. Gordon v. New York Stock Exchange, 422 U.S. 659 (1975); United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 734–35 (1975); Silver v. New York Stock Exchange, 373 U.S. 341 (1963).

38. 15 U.S.C. § 78f (2000).

39. Self-regulation by the NASD was added in 1938 by the Maloney Act, 52 Stat. 1070 (codified as amended at 15 U.S.C. § 78o-3 (2000)). *See generally* United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975) (discussing role of NASD).

40. This process has been most vividly described by Supreme Court Justice William O. Douglas, a former SEC chairman. His concept of self-regulation is:

> [O]ne of letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.

WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 82 (James Allen ed., 1940).

41. *See* 15 U.S.C. § 78o-4(b)(1), (c) (2000).

42. The American Stock Exchange was the first to seek to add options trading to its products after the creation of the CBOE. In the Matter of the American Stock Exchange, Inc. Plan to List and Trade Options, Exchange Act Release No. 34-11,144, (Dec. 19, 1974), 1974 SEC LEXIS 2108. The NYSE was at first uninterested in options trading and encountered opposition from the SEC when it did seek entry in later years. The SEC feared that options traded on the NYSE would be subject to abuse by specialists. It also expressed a similar concern with market makers trading over-the-counter op-

competition by requiring coordinated trading and clearance[43] under the aegis of a "central market" doctrine, adopted early in the 1970s.[44] After endeavoring to regulate competition on the

tions. *See* Termination of the Options Moratorium, Exchange Act Release No. 34-16,701, 19 S.E.C. Docket 998 (Mar. 26, 1980). This concern with side-by-side trading was not overcome by the SEC until 1985. It then allowed the NYSE to trade options, but required the exchange to conduct such trading from a location separate from its stock trading floor. 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (1970–2001), at 53 (2002) [hereinafter 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S.]. By that time, the market was too mature for successful competition by the NYSE, and it transferred its options operations to the CBOE in the mid-1990s. Dan Colarusso, *Investing: A New Options Market That Hums*, N.Y. TIMES, Dec. 16, 2001, Sec. 3, at 7.

43. Jerry W. Markham & David J. Gilberg, *Stock and Commodity Options — Two Regulatory Approaches and Their Conflicts*, 47 ALBANY L. REV. 741, 749–50 (1983).

44. As noted by one authority:

> [I]n 1971, in a letter transmitting its Institutional Investor Study to Congress, the SEC stated: "A major goal and ideal of the securities markets and the securities industry has been the creation of a strong central market system for securities of national importance, in which all buying and selling interest in these securities could participate and be represented under a competitive regime."
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> The SEC acknowledged that "this represented something of a shift in the historic position of the Commission, which over many years, extending from before World War II to at least the Special Study Report of 1963, tended to favor competing but separate markets." The shift was prompted not by any lessened concern over the dangers of consolidation, but, rather, by the *deus ex machina* of modern technology. The SEC and others saw in the technological developments in communications and computers a way to capture the benefits of consolidation without inhibiting competition.
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> In 1975, Congress indicated that it agreed with the SEC, enacting the Securities Acts Amendments of 1975, which called for the SEC to "facilitate the establishment of a national market system for securities." In this national market system the efforts of individual marketplaces to achieve consolidation at the expense of other marketplaces were to be displaced by a much grander national effort that would no longer recognize marketplace boundaries.

Jeffry L. Davis & Lois E. Lightfoot, *Fragmentation Versus Consolidation of Securities Trading: Evidence from the Operation of Rule 19c-3*, 41 J. L. & ECON. 209, 210–11 (1998).

The central market got nowhere in the stock markets. The SEC sought to require a "universal message switch" that would have required customer orders to be routed to the market with the best execution price. The agency was unable to mandate such a system and instead agreed to the creation of options exchanges for many years, the SEC finally began encouraging the multiple trading of options on the same securities.[45] Still, after the creation of the Nasdaq market the competition between the NYSE and the NASD was even fiercer,[46] and in later years led to criticism that the NASD had allowed its competitive role in marketing Nasdaq to outweigh its regulatory responsibilities.[47] In the end, the NASD was forced to separate and spin off its regulatory body into NASD Regulation, Inc. ("NASDR").[48]

The SEC regulatory structure also increased in complexity over the years with the introduction of other entities that have now been designated "gatekeepers,"[49] such as the accountants that certify the financial statements of public companies and broker-dealers.[50] Accountants had maintained control over

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the "Intermarket Trading System," under which exchange specialists execute orders at the best price available on any other exchange. This essentially meant that specialists on the regional exchanges would have access to NYSE quotes and could key off those quotes instead of competing separately. *See generally* U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, ELECTRONIC BULLS AND BEARS: U.S. SECURITIES MARKETS & INFORMATION TECHNOLOGY 47–48 (Sept. 1990) (description of universal message switch and Intermarket Trading System); U.S. GENERAL ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL COMMITTEES ON SECURITIES TRADING: SEC ACTION NEEDED TO ADDRESS NATIONAL MARKET SYSTEM ISSUES (March 1990) (description of central market system issues).

45. The SEC has been allocating options on particular stocks to the options exchanges by lottery. It was not until 1989 that the SEC allowed options on particular securities to be traded on more than one exchange. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 85. Thereafter, it sought to encourage such trading. *See* Multiple Trading of Standardized Options, Exchange Act Release No. 34-26,870, 43 S.E.C. Docket 1498 (May 26, 1989). The options exchanges were censured in 2000 for agreeing not to multiply list options as mandated by the SEC. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 331.

46. Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17 (1986) (description of development and growth of the Nasdaq market).

47. *See generally* In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 34-37,542, 62 S.E.C. Docket 1385 (Aug. 8, 1996) (describing collusion by Nasdaq market makers).

48. *Id.*

49. *See* Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001) (discussing role of gatekeepers and advocating liability).

50. The role of accountants was widely expanded by the adoption of the federal securities laws. Publicly owned companies were required to publish

their audit procedures for some time, though the SEC would occasionally intervene.[51] One concern was competition, i.e., that corporate management would shop for the least strict auditor. The SEC has attacked such practices,[52] and, further, adopted rules that sought to assure that auditors remained independent of their audit clients.[53] However, the independence standards were questioned after the SEC discovered that numerous partners in audit firms held stock in their audit clients.[54] Consulting operations created by accounting firms were also creating conflicts. As a result, the SEC acted to strengthen its independ-

certified accounting statements. The SEC also imposed auditing requirements on broker-dealers. Reports to be Made by Certain Brokers and Dealers, 17 C.F.R. § 240.17a-5 (2002) (FOCUS report requirement).

The gatekeeper role of accountants, and their "deep pockets," led to efforts to impose liability under the federal securities laws when a company unexpectedly failed during an accounting firm audit. The Supreme Court relieved the accounting profession of liability under SEC Rule 10b-5 (17 C.F.R. § 240.10b-5 (2002)) based on negligence in their audits. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Further protection was provided when the Supreme Court rejected private rights of action for aiding and abetting on the part of professionals such as accountants and lawyers. Central Bank v. First Interstate Bank, 511 U.S. 164 (1994).

51. The SEC deferred for the most part to the accounting profession in developing what are called "generally accepted accounting principles," or "GAAP." 2 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 9.6[1] (4th ed. 2002) [hereinafter HAZEN TREATISE]. The Financial Accounting Standards Board ("FASB"), an industry group, took the lead in developing or changing particular GAAP standards. *See generally* Marshall S. Armstrong, *The Work and Workings of the Financial Accounting Standards Board*, 29 BUS. LAW. 145 (1974) (describing role of FASB). Regulation S-X, however, imposed various accounting requirements in public offerings. Application of Regulation S-X (17 C.F.R. part 210), 17 C.F.R. §§ 210.1-01 to 210.1-02 (2002). The SEC has also adopted particular accounting standards in its filings by rule, and issues Accounting Series Releases on matters it deems not adequately addressed by the accounting profession.

Until recently, the American Institute of Certified Public Accountants ("AICPA") set "generally accepted auditing standards," or "GAAS." 2 HAZEN TREATISE, *supra* § 9.6[1]. The SEC further assumed the authority to discipline accountants that failed to meet what the agency deemed were appropriate auditing standards. 17 C.F.R. § 210.102(e) (2002).

52. 2 HAZEN TREATISE, *supra* note 51, § 9.6[1].

53. Qualifications of Accountants, 17 C.F.R. § 210.2-01(b) (2002).

54. In one large accounting firm, the SEC found that thirty-one of the top forty-three partners held stock in audit clients. A total of 8,000 violations of independence standards were found by partners and employees of the accounting firm. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 257.

ence standards.[55] Congress also jumped on the bandwagon and required auditors to report violations by their clients.[56] Most recently, the Enron debacle and other accounting scandals heightened regulatory concern over the role of these gatekeepers.[57] In the end, the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") created a Public Company Accounting Oversight Board to oversee the auditing principles and practices of auditors.[58]

Another set of gatekeepers is the Nationally Recognized Statistical Ratings Organizations ("NRSROs"), i.e., ratings agencies such as Moody's and Standard & Poor's. The SEC gave such organizations a quasi-official role in applying its net capital rule.[59] That status, and the increasingly important role of

55. Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 34-43,602, 65 Fed. Reg. 76,008 (Dec. 5, 2000).

56. Section 10A of the Securities Exchange Act of 1934 required audits to be conducted in accordance with GAAS. Independent auditors were required to conduct their audits in a manner that would uncover illegal activities and to report that conduct to management and to the board of directors if management fails to act. The board of directors must then report the violative activity to the SEC or if it fails to do so, the auditor must inform the SEC. 15 U.S.C. § 78j-1 (2000).

57. Enron Corporation was the seventh largest company on the Fortune 500 index when it failed in October 2001. After the Enron scandal, a number of other firms were also found to have engaged in various questionable accounting practices. Several energy companies were involved in "round trip" trades that artificially increased their income by billions of dollars. Global Crossing Ltd., a large telecommunications firm declared bankruptcy after an accounting scandal. It was followed by WorldCom, Inc., which had improperly booked some $7 billion in revenues. The bankruptcy of WorldCom was the largest such event in U.S. history, superseding Enron for that dubious honor. *See* Greg Hitt, *Bush Signs Sweeping Legislation Aimed at Curbing Corporate Fraud*, WALL ST. J., July, 31, 2002, at A4.

58. The Public Company Accounting Oversight Board took away control of accounting standards from the accounting profession. Accountants certifying the financial standards of public companies are now required to register with the Board and conform to the standards it sets. *See* Sarbanes-Oxley Act of 2002, §§ 101–09, Pub. L. No. 107-204, 116 Stat. 745. Some large accounting firms had already spun off consulting services (e.g., Accenture), and immediately after this legislation IBM purchased the consulting operations of another giant accounting firm. William Bulkeley & Kemba Dunham, *IBM Speeds Move to Consulting With $3.5 Billion Acquisition*, WALL ST. J., July 31, 2002, at A1.

59. For example, the SEC defers to the NRSROs in determining whether a "ready market" exists for purposes of valuing securities in inventory under its net capital rule. *See, e.g.*, Net Capital Requirements for Brokers and Dealers, 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E) (2002) (valuation of money instruments);

the ratings agencies, created the impression that these entities were gatekeepers. Although NRSROs compete with each other for business, critics have claimed that the ratings agencies do not fulfill their gatekeeping responsibilities due to the conflict of interest they face, i.e., their compensation is paid by the very companies they rate.[60] Sarbanes-Oxley now requires the SEC to conduct a study of the NRSROs and to report to Congress on any deficiencies, raising the likelihood that these gatekeepers will be subject to regulation in the future.[61]

Financial analysts are another class of securities sector participants that have been elevated to gatekeeper status. The Investment Advisers Act of 1940 first applied some regulation to this field.[62] However, Congress sought to limit this regulation to those entities rendering personal advice, which excluded publications to the general public, a distinction the SEC was unable to discern.[63] Financial analysts have also been a particularly sharp thorn in the SEC's side. While the analysts' product value depends to some degree on their ability to analyze the massive amounts of information influencing the value of the stocks, the real value they added over the years was their ability to obtain information that was not generally available to

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Capital Committee of the Securities Industry Association (c/o Merrill Lynch & Co.), SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,280, at 77, 051 (June 12, 1992) ("ready market" treatment for debt securities of foreign issuers).

60. *See generally* Frank Partnoy, *The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999) (describing shortcomings of rating agencies). The rating agencies were also criticized for not predicting the demise of the Enron Corporation. *See* Hearings before the United States S. Comm. on Governmental Affairs, 107th Cong. (2002) (testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law).

61. Sarbanes-Oxley Act of 2002, § 702.

62. Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2000). The investment adviser is relatively new to the securities industry, having appeared in force only after World War I. SECURITIES AND EXCHANGE COMMISSION, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION PURSUANT TO SECTION 30 OF THE PUBLIC UTILITIES HOLDING COMPANY ACT OF 1935: INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT FUTURE PRICES, AND INVESTMENT ADVISORY SERVICES 3 (1939) ("The emergence of investment counselors as an important independent occupation, or profession, did not appear until after the close of the World War").

63. Lowe v. SEC, 472 U.S. 181, 211 (1985).

the public. The SEC's mandate was full disclosure, but the agency wanted such disclosure only on its terms, prompting it to bring an insider trading case against an analyst that sold out his institutional clients when he learned of a massive fraud at Equity Funding, a company he had been following.[64] The Supreme Court threw out the case,[65] but the SEC remained concerned with the role of financial analysts.[66] Selective disclosure given to analysts by corporate officials was an informational advantage at which the SEC balked, and subsequently proscribed under Regulation FD.[67]

Denied this informational advantage as a product to sell, analysts were left to tout stocks like snake oil salesmen.[68] This led to scandal when it was discovered that Henry Blodget, an analyst at Merrill Lynch, had been publicly praising one stock while describing it as a "piece of junk" in an internal email.

64. Mitchell C. Lynch, *Security Analysis and the Law*, WALL ST. J., Sept. 15, 1978, at 16.

65. Dirks v. SEC, 463 U.S. 646 (1983).

66. Broker-dealers are required to maintain a "Chinese Wall" (an "inviolable wall" for the politically correct) between the analysts and the underwriting arms of the firm. Restricted lists are also used to assure that analysts do not have access to non-public information. *See generally* David A. Lipton & Robert B. Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459 (1975).

67. General Rule Regarding Selective Disclosure, 17 C.F.R. § 243.100 (2002). This regulation seems to be based on a bit of twisted government logic, i.e., full disclosure to everyone at the same time or no disclosure to anyone. In the apparent view of the SEC, it is better that the market not receive information that will more efficiently value a company unless everyone has the information at precisely the same time. The SEC should be encouraging information flows, not discouraging access by professionals who will be paid for ferreting out material information, analyzing it, and disseminating it to the market through their clients. *See generally* Jerry Duggan, *Regulation FD: SEC Tells Corporate Insiders to "Chill Out,"* 7 WASH. U. J.L. & POLICY 159 (2001) (criticizing Regulation FD).

68. Mary Meeker, an analyst at Morgan Stanley, was given the title of "queen of the net" for hyping IPO internet stock offerings that her firm was underwriting. JOHN CASSIDY, DOT.CON, THE GREATEST STORY EVER SOLD 206-17 (2002). *See also generally* Randall Smith & Susanne Craig, *Will Grubman Case Tone Down the Exaggeration by Analysts?*, WALL ST. J., Sept. 24, 2002, at C1. Jack Grubman, an analyst at Salomon Smith Barney, was alleged to have pumped telecommunications stocks so that his firm could obtain their underwriting business. Charles Gasparino, *Salomon's Grubman Resigns: NASD Finds "Spinning" at Firm*, WALL ST. J., Aug. 16, 2002, at A1; Charles Gasparino, *Salomon Agrees to Settle Stock-Hype Case*, WALL ST. J., Sept. 24, 2002, at C1.

Merrill Lynch was fined $100 million after this was discovered.[69] The fine was imposed by Eliot Spitzer, the New York State Attorney General, whose recent crusades provide evidence of another layer of regulation in the securities industry.[70] Finally, Sarbanes-Oxley sought to further separate the analysts from their investment banking associates and gave the SEC authority to adopt rules for that purpose.[71] The SEC, thereafter, began examining proposals to require analysts to be independent of their investment banking colleagues.[72]

Sarbanes-Oxley added still another gatekeeper, as the SEC was given authority to issue rules setting forth standards of conduct for attorneys advising public companies.[73] Attorneys are now required to report violations of securities laws, *inter alia*, to a board committee composed entirely of outside directors if the company fails to take corrective action.[74] This means that lawyers are now policemen and not just advisors.[75] Moreover, the reference to outside directors is further evidence of yet another gatekeeper — the outside director himself.[76] The SEC has long attempted to strengthen the role of these directors, to

69. Patrick McGeehan, *E-Mail Gaps May Mean Fines for Big Firms*, N.Y. TIMES, Aug. 2, 2002, at C1.

70. *See infra* note 429 and accompanying text.

71. *See* Sarbanes-Oxley Act of 2002, § 501, Pub. L. No.107-204, 116 Stat. 745 (2002).

72. Michael Schroeder, *SEC to Consider Step in Analysts' Independence*, WALL ST. J., Sept. 9, 2002, at C7.

73. The SEC adopted the Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release Nos. 33-8185, 34-47,276, 17 C.F.R. Part 205 (S.E.C. Jan. 29, 2003), *available at* www.sec.gov/rules/final/33-8815.htm.

74. 17 C.F.R. § 205.3(b)(3); Sarbanes-Oxley Act of 2002, § 307.

75. Such a role for lawyers had been rejected many years ago. A scandal at the National Student Marketing Corporation resulted in a drive by the SEC to punish lawyers representing companies violating the federal securities laws. *See* Stan Crock, *SEC to Consider Rule Requiring Lawyers to Disclose Fraud by Corporate Clients*, WALL ST. J., Aug. 3, 1978, at 5 (American Bar Association asserts that lawyers are advisors and not policemen). However, the SEC later rejected a proposal that would have required corporate lawyers to report management wrongdoing to the board of directors and to the SEC. *See SEC Rejects Bid to Force Firms' Lawyers to Tell Boards of Employee Wrongdoing*, WALL ST. J., May 1, 1980, at 4 (SEC defers to ABA on this issue).

76. The NYSE has also ruled that outside directors must constitute a majority of the board of directors of publicly owned corporations listed on the exchange. Gaston Ceron, *Deals & Deal Makers: NYSE to Firm Governance, Add Trading Floor*, WALL ST. J., Aug. 2, 2002, at C5.

the point of seeking to require all but one director to be independent of management, thereby leaving the running of a company in the hands of those unfamiliar with its day-to-day operations.[77] Finally, various "whistleblower" statutes seek to protect employees reporting misconduct.[78] One such employee achieved fame for reporting Enron's questionable accounting practices to senior management before they became publicly known.[79] Sarbanes-Oxley enshrines her act into legislation by requiring public corporations to adopt procedures to encourage such whistleblowing.[80]

If all of these gatekeepers and regulators are not enough, there are still real gorillas to contend with — the private attorneys general bringing class action lawsuits under the federal securities laws.[81] As corporate America was drowning in a mo-

77. *See* Burt Schorr, *Board Breakup, Corporate Directors Scored for Lax Scrutiny of Managements' Acts*, WALL ST. J., Apr. 10, 1978, at 1 (describing efforts by SEC to make corporate board more independent of management). In 1978 the NYSE began requiring its listed companies to have an audit committee composed of outside directors. Peter F. Drucker, *The Real Duties of a Director*, WALL ST. J., June 1, 1978, at 20. An SEC Chairman went so far as to advocate that management should have only one slot on the board of directors. *Management Should Fill Only One Seat on of Firms' Board of Directors*, WALL ST. J., Jan. 19, 1978, at 3. The SEC Chairman soon had to backtrack from this wild proposal. *Letters to the Editor*, WALL ST. J., Nov. 2, 1978, at 22. *Compare*, Joann S. Lublin, *Outsiders In, Firms Add More Independent Directors, But Finding Doing So Can Mean Headaches*, WALL ST. J., May 26, 1978, at 38 (describing shortcomings of outside directors), *with*, Joann S. Lublin, *How CEOs Retire in Style*, WALL ST. J., Sept. 13, 2002, at B1 (describing twenty-four years later lucrative compensation given to executives after negotiation with independent directors). *See generally SEC Report Warns Outside Directors of Duty to Investors*, WALL ST. J., Jan. 18, 1978, at 3 (outside directors should have called board meeting to challenge management disclosures or should have resigned).

78. *See, e.g.,* 5 U.S.C. § 2301(b)(9) (2000) (federal whistleblower statute); KY. REV. STAT. ANN. § 61.102 (2002) (state whistleblower statute). The California Senate has passed a bill that would require corporate officers to report accounting abuses to the attorney general. Robert Salladay, *"Snitch" Bill Passed by State Senate*, S.F. CHRON., June 21, 2002, at A17.

79. *See Newsmakers*, HOUSTON CHRONICLE, May 22, 2002, at A2. Sherron Watkins honored for disclosing questionable accounting practices at Enron to the Company's Chief Executive Officer, Ken Lay. She did not report the problem to any regulator. *Id*.

80. Sarbanes-Oxley Act of 2002, § 806, Pub. L. No.107-204, 116 Stat. 745.

81. Broker-dealers might be viewed either as gatekeepers or as a part of the SRO structure. Broker-dealers are required to register with the SEC (15 U.S.C. § 78o (2000)) and to supervise their employees (15 U.S.C. §

rass of litigation from these plaintiffs, efforts to curb some of the worst abuses led to the passage of the Private Securities Litigation Reform Act of 1995.[82] Nonetheless, the amount of litigation only increased.[83] Additional pressure was coming from an increasingly active Justice Department that had created special units in several of its U.S. Attorney offices to prosecute securities violators. Sarbanes-Oxley furthers that effort by increasing criminal penalties for violations of the federal securities laws to draconian levels.[84] Another phenomenon of recent years has been the attorney general "wolf packs" that are attacking businesses, including Microsoft and the tobacco compa-

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78o(b)(4)(E), (G)(iii) (2000)). *See also* Bevis Longstreth, *Duty to Supervise is Critical to Effective Self-Regulation*, NAT. L.J., May 16, 1983, at 24. Broker-dealers are also subject to the rules of the exchanges of which they are members and to the rules of NASDR. Adoption of Rules under Section 15(b)(10) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-8135 [1966-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,459, at 82,890 (July 27, 1967).

82. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. The abuses in litigation included the use of "professional plaintiffs" to bring class action lawsuits and the routine filing of lawsuits whenever there was a significant change in the price of a stock. Jordan Eth & Daniel S. Drossman, *The Private Securities Litigation Reform Act: Five Years Young*, 34 Sec. & Commodities Reg. 153, 153 n.3 (July 2001). *See generally* Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009 (1996) (describing abuses). The Private Securities Litigation Reform Act of 1995 was avoided by bringing class actions in state court. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. The Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, sought to plug that loophole, but another gap was found. *See* Joshua D. Ratner, *Shareholders' Holding Claim Class Actions Under State Law After the Uniform Standards Act of 1998*, 68 U. CHI. L. REV. 1035 (2001).

83. Critics claim that reform efforts to curb abusive litigation have had little effect. *Id. Compare Common Sense Legal Reform Act, Hearings on H.R. 10 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong., 73–86 (1995) (testimony of William S. Lerach, partner, Milberg Weiss Bershad Hynes & Lerach) (statistics suggesting that there was no inordinate increase in the number of class action lawsuits involving securities claims), *with* CORNERSTONE RESEARCH, POST REFORM ACT SECURITITES CASE SETTLEMENTS, 2001: A YEAR IN REVIEW (2002). This study by the Stanford Law School Securities Class Action Clearing House and Cornerstone Research found a 60% increase over 2000 in the number of class actions filed. The companies who were defendants in those actions lost more than $2 trillion in market capitalization after those suits were filed. *Id.*

84. *See* Sarbanes-Oxley Act of 2002, § 1106.

nies, on a national scale, thereby setting their own national regulatory policies.[85]

D. Commodity Futures and Options

Like the securities sector, the regulation of commodity futures trading was cordoned off from other parts of the financial services industry. That decision was again the result of history, rather than the implementation of a measured economic theory of regulatory competition. In response to the agricultural recession that followed World War I, Congress enacted the Futures Trading Act of 1921,[86] which was then declared unconstitutional by the Supreme Court as an impermissible use of the congressional taxing powers.[87] A manipulation of grain prices occurring just a few days after the Supreme Court's decision, however, convinced Congress that regulation was needed,[88] and it passed the Grain Futures Act of 1922[89] under its commerce powers. This legislation was upheld as constitutional by the Supreme Court.[90]

The Grain Futures Act required commodity futures trading to be conducted on organized exchanges, such as the Chicago Board of Trade, which would register with the government as "contract markets."[91] The goal was to stop "bucket shop" opera-

85. *See* Michael Freedman, *Wall Street's Worst Nightmare*, FORBES, Aug. 12, 2002, at 44 (describing tactics of attorney general wolf packs and noting that Alabama securities administrator wants to pursue Wall Street); Russell Gold & Andrew Caffrey, *United Crimebusters*, WALL ST. J., Aug. 1, 2002, at B1 (describing attorney general network). The Connecticut Supreme Court recently held that the state attorney general did not have standing to bring action to correct wrongs wherever they might be found. Blumenthal v. Barnes, 804 A.2d 152 (Conn. 2002). Eliot Spitzer, the New York Attorney General, has been particularly aggressive in attacking businesses in order to garner publicity for himself. *See infra* note 429 and accompanying text.

86. Futures Trading Act, ch. 86, 42 Stat. 187 (1921). This legislation was preceded by an intensive study of the grain markets by the Federal Trade Commission ("FTC"), which found numerous abuses. 1–7 FED. TRADE COMM'N, REPORT OF THE FED. TRADE COMM'N ON THE GRAIN TRADE (1920–1921).

87. Hill v. Wallace, 259 U.S. 44, 71 (1922).

88. H.R. REP. NO. 67-1095, at 2 (1922).

89. Commodity Exchange Act (Grain Futures Act), ch. 369, 42 Stat. 998 (1922) (codified as amended at 7 U.S.C. §§ 1–25 (2000)).

90. Board of Trade v. Olsen, 262 U.S. 1, 42 (1923).

91. Grain Futures Act, ch. 369, §§ 5–7, 42 Stat. 998, 1000 (1922).

tions that were fleecing unsuspecting investors[92] and to provide some regulatory controls that would halt the manipulation of agricultural commodity prices that all too often roiled the markets.[93] The Act was administered by the Grain Futures Administration, an agency within the Department of Agriculture.[94] It proved to be unsuccessful in stopping manipulations or preventing devastation in the agricultural community during the Great Depression, when prices dropped to unprecedented lows.[95]

President Roosevelt added to his call for regulation of the securities markets a request for legislation to regulate the futures markets.[96] History intervened to assure that such regulation

92. Bucket shops accepted customer orders and funds but did not execute the orders on any exchange. Rather, they simply bet the customer would lose and kept the customer's funds in such an event. If the customers won too much, the bucket shop would fold its operations and move to a new location. JOHN HILL, JR., GOLD BRICKS OF SPECULATION 37–39 (1904). The Supreme Court had already provided an effective means for stopping the bucket shops, i.e., shutting off the quotations from the legitimate exchanges on which the bucket shop operators relied for their trading. *See* Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 252–53 (1905) (upholding cutting off quotations to the operations of C.C. Christie, the "Bucket Shop King").

93. Price manipulations were occurring on a monthly basis on the Chicago Board of Trade. *See* Jerry W. Markham, *Manipulation of Commodity Futures Prices — The Unprosecutable Crime*, 8 YALE J. ON REG. 281 (1991) [hereinafter Markham, *Manipulation*]. The traders conducting manipulations became legends. *See* Leon Kendal, *The Chicago Board of Trade and the Federal Government: A Study in their Relationship, 1848 to 1952,* at 56 (Masters Thesis, Ind. U. School of Bus. 1956) (on file with author) ("The feats of Leiter, Armour, Patten, and others in cornering the markets are legends of American commerce.").

94. GEORGE WRIGHT HOFFMAN, FUTURE TRADING UPON ORGANIZED COMMODITY MARKETS IN THE UNITED STATES 372 (1932). The Grain Futures Administration was subject to oversight by a commission composed of the Secretary of Commerce, the Secretary of Agriculture and the Attorney General. Grain Futures Act, ch. 369, § 6, 42 Stat. 998, 1001 (1922).

95. By 1932, wheat prices were at a three-hundred-year low, and a bushel of corn cost less than a pack of chewing gum. *Wheat's Plunge to a 300 Year Low*, THE LITERARY DIGEST, Nov. 12, 1932, at 6.

96. The President's message stated that:

> It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.

would be separately conducted. The agricultural committees in Congress had jurisdiction over the commodity exchanges, while the banking committees controlled securities matters. Neither would cede authority to the other. The agricultural committees acted somewhat more slowly than the banking committees and were unable to pass legislation until 1936. The result, the Commodity Exchange Act of 1936,[97] continued much of the legislative approach of the Grain Futures Act. The name of the Grain Futures Administration was changed to the Commodity Exchange Authority, which was still subject to oversight by the same three cabinet officials ("Commodity Exchange Commission").[98] The analogue to the securities broker-dealer in the commodity futures business is the futures commission merchant ("FCM"). These firms were required to register as such with the government under the Commodity Exchange Act[99] and to segregate customer funds into trust accounts.[100] Option trading was prohibited on regulated commodities.[101]

Manipulation of commodity prices was also prohibited — but that term was not defined in the Commodity Exchange Act of 1936, and the government proved unable to stop such practices.[102] Scandals in commodity options on unregulated commodities in the early 1970s raised concern in Congress,[103] and the incredible inflation in commodity prices during that period

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> I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of *exchanges dealing in securities and commodities* for the protection of investors, for the safeguarding of values, and so far as it may be possible for the elimination of unnecessary, unwise, and destructive speculation.

H.R. REP. NO. 74–421, at 2 (1935) (emphasis added).

97. Commodities Exchange Act of 1936, ch. 545, 49 Stat. 1491 (1936) (codified as amended in scattered sections of 7 U.S.C.).

98. JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 27 (1987) [hereinafter MARKHAM, HISTORY OF COMMODITY FUTURES TRADING].

99. 7 U.S.C. § 6f(a) (2000).

100. 7 U.S.C. § 6d (1990).

101. 7 U.S.C. § 6c(b) (2000).

102. *See* Markham, *Manipulation, supra* note 93, at 313–23 (describing unsuccessful government actions against manipulative activities in the futures markets).

103. *See infra* notes 146–57 and accompanying text.

also led to calls for additional legislation.[104] It came in the form of the Commodity Futures Trading Commission Act of 1974,[105] which carried forward the provisions of the Commodity Exchange Act and created the CFTC. The agency was given exclusive jurisdiction over the trading of commodity futures and commodity options on all commodities.[106] Moreover, the CFTC was given increased enforcement powers,[107] and the regulatory reach of the Commodity Exchange Act was expanded to include commodity trading advisors, commodity pool operators, and associated persons of futures commission merchants.[108]

III. DISTINCTIVE REGULATION DEVELOPS BETWEEN SECURITIES AND FUTURES

During the first forty years of its existence, the SEC found little reason to compete with the Commodity Exchange Authority ("CEA"), as commodity futures and securities operated more or less independently. Indeed, while considering the adoption of the Commodity Exchange Act of 1936, Congress found that some large speculators had transferred their manipulative activities from the stock markets to the grain exchanges in order to escape regulation under the Securities Exchange Act of 1934.[109] SEC Chairman William O. Douglas, therefore, sought further regulation of grain speculators, especially those dealing in puts and calls.[110] President Roosevelt responded by asking his Secretary of Agriculture, Henry Wallace, to take action

104. *See id*.

105. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified in scattered sections of 7 U.S.C.).

106. 7 U.S.C. § 2 (2000).

107. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified in scattered sections of 7 U.S.C.).

108. 7 U.S.C. § 6k (2000) (associated person registration requirement); 7 U.S.C. § 6n (2000) (commodity trading advisor and pool operator registration requirement).

109. MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 25. At least one large and vicious speculator crossed over the other way, i.e., from the commodity exchanges to the stock markets during the 1920s. This individual, Arthur Cutten, was involved in numerous commodity manipulations before moving his activities and operating on an even grander scale in the securities markets. *Id.* at 26.

110. *See* 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 143.

against the commodity exchanges.[111] Wallace refused to do so, viewing the SEC's concern as mere pretense, cloaking a power grab by the very ambitious Douglas.[112]

The regulatory structures governing securities and commodity futures were thus allowed to develop separately and distinctively. While the cornerstone of SEC regulation is full disclosure to the public in securities offerings, there is no comparable concept in the Commodity Exchange Act of 1936. The SEC was also given authority to enforce margin requirements for securities set by the Federal Reserve Board, a device Congress concluded would curb speculation and avoid the diversion of scarce credit into such activities.[113] The CEA, on the other hand, possessed no such authority and had informed Congress during the hearings on the Commodity Exchange Act of 1936 that such authority was not needed. Rather, the CEA wanted to impose limits on the amount of trading that could be conducted by the large speculators, who at the time were the principal perpetrators of market manipulations.[114] Such authority was granted by Congress in the Commodity Exchange Act of 1936.[115] The SEC had no comparable power. Although the CEA changed its position not long afterward and sought authority to control margins as well — after its position limits proved ineffective in curbing price rises in commodity markets — Congress refused to grant the CEA this power.[116] Margins on futures were considered a

111. *Id.*
112. *Id.* at 225.
113. 15 U.S.C. § 78g (2000). Margin requirements are set under Federal Reserve Board Rules, the most prominent of which is Regulation T. Credit by Brokers and Dealers, 12 C.F.R. §§ 220.1–220.18 (2002). The Federal Reserve Board changed margin requirements some twenty-five times after the adoption of the Securities Exchange Act of 1934 in order to squelch speculation in the case of increases or to ease access to the market during downturns. Today, most actively traded stock is subject to a margin requirement of 50%. 23 MARKHAM & HAZEN, *supra* note 35, §§ 3.01–3.02.
114. *See* Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry — History and Theory*, 64 TEMP. L. REV. 59, 69–71, 71 n.60 (1991) [hereinafter Markham, *Federal Regulation of Margin*].
115. *See* 7 U.S.C. § 6a(c) (2000) (authorizing position limits for speculators and exempting "bona fide" hedging from their application). *See also generally* United States v. Cohen, 448 F.2d 1224 (2d Cir. 1971) (speculative limit violations); Kent v. Hardin, 425 F.2d 1346 (5th Cir. 1970); Goodman v. Benson, 286 F.2d 896 (7th Cir. 1961).
116. Markham, *Federal Regulation of Margin*, *supra* note 114, at 71–80.

device to protect the exchanges and futures commission merchants from customer defaults, rather than a credit allocation issue or a means to control speculation.[117] Congress thought that the commodity exchanges were in a better position than the government to assure that margin levels were adequate for their protection.[118]

Although both agencies had antifraud provisions to administer, the Commodity Exchange Act provision was more narrowly focused and was never given the expansive interpretation applied to Section 10(b) of the Securities Exchange Act of 1934.[119] That section was the most broadly applied of the antifraud provisions administered by the SEC; it was pursuant to that section that the SEC adopted Rule 10b-5.[120] The rule applies to all securities transactions, and the SEC has used this authority to create entire regulatory programs, the most famous being its insider trading prosecutions.[121] Demonstrating the flexibility of Rule 10b-5, the SEC's insider trading program was not begun until over a quarter of a century after the agency was created, and almost twenty years after the adoption of the rule.[122] Although sometimes likened to Section 10(b) of the Securities Exchange Act of 1934, Section 4b of the Commodity Exchange Act of 1936[123] was limited to specific fraudulent practices made in

117. *Id.*

118. *Id.* at 76. This did not stop the government from jawboning and threatening the commodity exchanges with more regulation if they did not increase margins during periods of major price increases. *Id.* at 80.

119. 15 U.S.C. § 78j(b) (2000).

120. Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2002).

121. 2 HAZEN TREATISE, *supra* note 51, § 12.3[2] (describing adoption and expansion of the application of Rule 10b-5). The SEC has not been shy in creating substantive regulation through litigation in other areas, such as questionable payments to foreign government officials in order to obtain business. ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 153–159 (1982).

122. Rule 10b-5 was adopted in 1942. Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2002). The SEC did not prosecute insider trading under this rule until 1961. *See* In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961). Even then, Rule 10b-5 did not receive much attention for insider trading purposes for another seven years, when it was given its most expansive interpretation in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied, sub nom.*, Coates v. SEC, 394 U.S. 976 (1969).

123. 7 U.S.C. § 6b (2000).

connection with futures traded on contract markets.[124] There was no interest by commodity regulators in creating an insider trading program in the futures industry.[125]

Additional disparities existed in the two regulatory schemes. A cornerstone of SEC broker-dealer regulation became the suitability requirement, i.e., a broker-dealer may not recommend securities to a customer that are unsuitable in light of the customer's own particular financial circumstances and objectives[126] — a doctrine that the SEC created out of whole cloth.[127] The CEA, on the other hand, invented no comparable regulatory concept. The Commodity Exchange Act of 1936 prohibited over-the-counter dealings in commodity futures; the contract markets were given a monopoly on such transactions, at least

124. The Supreme Court has casually compared Section 4b in the Commodity Exchange Act with Section 10(b) of the Securities Exchange Act of 1934. *See* Merrill Lynch, Pierce Fenner & Smith Inc. v. Curran, 456 U.S. 353 (1982). But in fact, the language and application of Section 4b has been more narrowly focused, i.e., it applies only to commodity futures trading on contract markets. *See* 13 JERRY W. MARKHAM, COMMODITIES REGULATION: FRAUD, MANIPULATION & OTHER CLAIMS §§ 1.01–1.08 (2001) [hereinafter MARKHAM, FRAUD, MANIPULATION & OTHER CLAIMS] (describing judicial decisions interpreting Section 4b). The CFTC did adopt antifraud rules for other products such as commodity options (17 C.F.R. § 32.9 (2002)), foreign futures contracts, (17 C.F.R. § 30.9 (2002)), and leverage contracts, Fraud in Connection with Certain Transaction in Silver or Gold Bullion or Bulk Coins, or Other Commodities, 17 C.F.R. § 31.3 (2002). The CFTC had tried to model its commodity options rule after SEC Rule 10b-5, but was forced to retreat in the face of industry opposition. The CFTC did keep Rule 10b-5 language in its antifraud rule for leverage contracts. 13 MARKHAM, FRAUD, MANIPULATION & OTHER CLAIMS, *supra,* § 2.08.

125. *See* discussion *infra* notes 169–71 and accompanying text.

126. *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557 (1999) (describing suitability doctrine).

127. The suitability doctrine was borrowed from the NYSE's "know your customer" rule. The exchange rule sought to protect member firms from unscrupulous "freeriding" customers that bought stock and paid only if the stock price increased. The SEC turned that concept on its head and imposed the suitability obligation on broker-dealers as a customer protection measure. This was done under the SEC's "shingle" theory, which posits that, in hanging out its shingle, a broker-dealer represents to the public that the broker-dealer is a professional and customers may rely on that expertise for suitable recommendations. *See generally* 23A MARKHAM & HAZEN, *supra* note 35, § 9.01 (describing basis of suitability doctrine).

for the "regulated" commodities.[128] The SEC, in contrast, regulated a broad-based over-the-counter market[129] and imposed affirmative obligations on market makers and exchange specialists to make a "fair and orderly" market, i.e., a market that was not volatile.[130] No such requirement was imposed on the floor traders on the commodity exchanges. Instead, trading was conducted in an auction-style open outcry system in which traders could participate, or not, as they chose.[131]

SEC regulation was paternalistic in other ways. It imposed a duty of supervision on broker-dealers that required them to affirmatively supervise their employees with a view toward preventing violations.[132] The CEA, in contrast, imposed no such obligation on futures commission merchants.[133] However, the

128. 7 U.S.C. § 7 (2000). *See generally* Jerry W. Markham, *The Commodity Exchange Monopoly — Reform is Needed,* 48 WASH. & LEE L. REV. 977 (1991) [hereinafter Markham, *The Commodity Exchange Monopoly*] (describing ill effects of the commodity exchange trading requirement).

129. This is not to suggest that the SEC was without sin. It allowed the NYSE to enforce a rule against its members that prohibited trading of listed stocks except through the exchange. This gave rise to the "third" and "fourth" markets in listed stocks by non-members. The SEC tried to hack away at the rule by prohibiting its application to trading on other exchanges and then to newly listed securities. Finally, the NYSE capitulated and repealed the rule in 1999. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 332.

130. 15 U.S.C. § 78k(b) (2000). *See* Shultz v. SEC, 614 F.2d 561, 563–64 (7th Cir. 1980) (describing market-making obligations). The Nasdaq market uses competitive market makers, while the stock exchanges use the specialist, but both have affirmative market-stabilizing obligations. 23A MARKHAM & HAZEN, *supra* note 35, § 10.01 (describing market making obligations).

131. *See* Markham, *Manipulation, supra* note 93, at 363–76 (comparing market-making obligations on commodity and security exchanges). Block positioning was encouraged in the securities industry, but was prohibited in the futures markets. *Id*. at 374.

132. *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Broker-Dealer Supervision: A Troublesome Area*, 25 SETON HALL L. REV. 527 (1994) (describing supervisory duty).

133. The Commodity Exchange Act of 1936 did impose liability on futures commission merchants for the acts of their agents. 7 U.S.C. § 2a (2000). There was no comparable provision in the federal securities laws, but the SEC claimed that such liability was appropriate even without authorizing legislation. *Compare* Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) (overruling *en banc* an earlier decision that had rejected *respondeat superior* liability) *and* Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967) (rejecting agency liability), *with, e.g.*, Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974) (applying *respondeat superior* liability). The SEC did have the authority to sanction controlling persons. 15 U.S.C. § 78t(a); 15 U.S.C. § 77o (2000). That

CEA did have a large trader reporting system, a power that the SEC did not receive until 1990.[134] The CEA required large traders to file a report disclosing the identity of the trader and any affiliates or entities under common control. The size of the trader's position was then monitored by the CEA to assure that the trader posed no danger to the market.[135]

Though the securities and commodity futures regulatory schemes differed, no one really noticed before the 1970s. The product mix of the two industries was such that, aside from some mobile speculators, there was little overlap between commodity and futures trading.[136] The situation began to change dramatically as inflation heated the economy during the Vietnam War.[137] The resulting price hikes turned investors' attention toward inflation hedges such as gold and silver. The removal of restrictions on trading allowed these metals to be the subject of commodity futures trading. Similarly, President Nixon's removal of the U.S. from the gold standard and out of the International Monetary Fund's fixed rate currency regime led to fluctuating exchange rates that provided a basis for currency trading.[138]

power was not added to the Commodity Exchange Act until 1982. 7 U.S.C § 13c(b) (2000).

134. This authority was given to the SEC by the Market Reform Act of 1990, § 3, Pub. L. No. 101-432, 104 Stat. 963 (amending 15 U.S.C. § 78m(h)). The SEC proposed a rule implementing this authority. *See* Large Trader Reporting System, Exchange Act Release No. 34-33,608, 59 Fed. Reg. 7917 (Feb. 17, 1994). However, it has not been adopted.

135. *See generally* In the Matter of International Futures Corp., Comm. Fut. L. Rep. (CCH) ¶ 27,993 (C.F.T.C. 2000) describing prior violations of CEA large trader reporting requirements), *aff'd, without opinion*, Commodity Futures Trading Comm'n v. Hunt, 559 F.2d 1224 (7th Cir. 1977).

136. Broker-dealers engaging in securities activities often had separate departments that conducted commodity futures trading for customers. This required dual registration under the Commodity Exchange Act of 1936 and the Securities Exchange Act of 1934.

137. The inflation that occurred in the 1970s led to many "hard" money investment programs that would inflate with the economy. *See* 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 61 (describing these programs).

138. *See generally* LEO MELAMED & BOB TAMARKIN, ESCAPE TO THE FUTURES (1996) (describing creation of futures markets on currency).

Price volatility also led the commodity exchanges to consider commodity futures trading on interest rates and stock prices.[139] A committee of the Chicago Board of Trade began to explore whether commodity futures trading principles could be applied to stocks. The result was the CBOE.[140] Prior to the creation of the CBOE, stock options were sold only on a limited basis in the over-the-counter market. The CBOE introduced a commodity futures concept of trading standardized options contracts on an exchange floor. This standardization, along with the introduction of a clearing house, the Options Clearing Corporation ("OCC"), created a secondary market in options. The CBOE trading floor borrowed from both the securities and commodity exchanges. Instead of a specialist, competing market makers were used to create liquidity in an open outcry system like that on the commodity exchanges.[141]

The SEC asserted regulatory control over the CBOE under the provisions of the Securities Exchange Act of 1934,[142] and also became involved in the regulation of over-the-counter commodity options. A loophole in the Commodity Exchange Act of 1936 allowed options trading on "unregulated" commodities, such as sugar, coffee, and silver. Harold Goldstein, a twenty-six year old commodity trader discovered this and built one of the largest brokerage firms almost overnight through the sale of "naked" options, not backed by anything other than the dubious credit of Goldstein's firm, Goldstein, Samuelson. However, increasing prices resulted in customer gains that Goldstein could not cover. The SEC shut down his and similar options firms by claiming that these contracts were securities.[143] State securities

139. For a description of these events, see 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 42–43.

140. Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137, 1140 n.2 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982).

141. *See* Markham & Gilberg, *supra* note 43, at 743–45 (describing the CBOE trading system).

142. 15 U.S.C. § 78i(b) (2000). A court later noted that, if the CFTC had been in existence when the CBOE was created, the CFTC, rather than the SEC, would have had jurisdiction. *Board of Trade of the City of Chicago*, 677 F.2d at 1140 n.2.

143. *See, e.g.*, SEC v. Commodity Options Int'l, Inc., 553 F.2d 628 (9th Cir. 1977); SEC v. American Commodity Options Exch., Inc., 546 F.2d 1361 (10th Cir. 1976).

administrators aided the SEC in these efforts, and Goldstein was finally jailed.[144]

The Goldstein, Samuelson debacle caused concern in Congress, as did the large jump in commodity prices during this period.[145] Congressional hearings found fault with the CEA's deference to the commodity exchanges,[146] and Congress concluded that new legislation was needed to close the regulatory gap in the Commodity Exchange Act that had allowed Goldstein, Samuelson to operate. Congress thought that all commodity options and futures trading should be subject to regulation,[147] and thus the Commodity Futures Trading Commission Act of 1974 ("CFTCA") created the CFTC[148] and brought all commodity futures and options trading under a "single regulatory umbrella."[149] The CFTC was "patterned" after the SEC and was granted strengthened enforcement powers,[150] including authority to seek injunctive relief,[151] a favorite weapon employed

144. *See generally* Robert C. Lower, *The Regulation of Commodity Options*, 1978 DUKE L.J. 1095 (1978) (describing Goldstein's operations and resulting regulation); Note, *The Role of the Commodity Futures Trading Commission Under The Commodity Futures Trading Commission Act of 1974*, 73 MICH. L. REV. 710, 721 n.8 (1975) (describing losses).

145. Soybean prices increased by over $8 per bushel in one five-month period. MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 56–57. A large sale of grain to the Soviet Union caused a spike in wheat prices and led to claims that the Soviets and various grain companies had profited on those transactions by advance purchases on the futures markets — the "Great Grain Robbery." DAN MORGAN, MERCHANTS OF GRAIN 12–121 (1979) (observing that the grain robbery was a world-changing economic event).

146. MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 60–65.

147. The Commodity Exchange Act of 1936 regulated futures trading only on specified commodities. Additional commodities were added to that list over the years, but such *ad hoc* amendments could not keep pace with the continual expansion of futures trading to other commodities.

148. Commodity Futures Trading Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (amending 7 U.S.C. §§ 2, 4).

149. H.R. REP. NO. 93-975 at 42 (1974).

150. 120 CONG. REC. 30467 (1974) (remarks of Sen. Taft). The CFTC was to be comparable to the SEC in its regulatory role. *See generally* S. REP. NO. 93-1131 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843; 120 CONG. REC. 10741 (1974) (remarks of Rep. Adams).

151. Commodity Exchange Act, 7 U.S.C. § 13a-1 (2000). The CEA had sought such authority in 1968, but the authorizing legislation was blocked in Congress by the commodity exchanges. Jerry W. Markham, *Injunctive Ac-*

by the SEC.[152] Self-regulation by the commodity exchanges was also strengthened.[153] The National Futures Association was later created to act as an analogue to the NASD.

The CFTCA further gave the CFTC certain authority that the SEC did not possess: the CFTC could impose civil penalties of up to $100,000 per violation[154] (a power that the SEC did not receive until 1984),[155] bar violators from trading on contract markets[156] (a power that the SEC was not given), and grant reparations to investors injured by violations committed by registered persons (again, this was not a power granted to the SEC).[157]

There were other differences in regulation between the two agencies. Congress passed the Securities Investor Protection Act ("SIPA") in 1970,[158] after the securities industry nearly collapsed during the "paperwork crisis" at the end of the 1970s.[159]

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tions under the Commodity Exchange Act, Sec. Reg. & L. Rep. (BNA) No. 504, at B-1 (May 23, 1979).

152. *See generally* Harvey L. Pitt and Jerry W. Markham, *SEC Civil Injunctive Actions: A Reply*, 6 REV. SEC. REG. 955 (1973) (describing importance of injunctive actions in SEC enforcement program). Professor Karmel has charged that the SEC has used its injunctive actions, which often end in consent decrees, to create substantive regulation. *See generally* KARMEL, *supra* note 121. Interestingly, the CFTC rarely brings injunctive actions and instead prefers to initiate administrative disciplinary proceedings.

153. Jerry W. Markham & John M. Schobel, *Self-Regulation Under the Commodity Exchange Act — Can the CFTC Make It Work?,* Sec. Reg. & L. Rep. (BNA) No. 368 (Special Supp. Sept. 1, 1976).

154. Commodity Exchange Act, 7 U.S.C. § 9 (2000).

155. The SEC was given the power to seek civil penalties for insider trading by the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

156. 7 U.S.C. § 9 (2000).

157. 7 U.S.C. § 18 (2000). *See generally* William R. Schief & Jerry W. Markham, *The Nation's "Commodity Cops" — Efforts by the Commodity Futures Trading Commission to Enforce the Commodity Exchange Act*, 34 BUS. LAW. 19 (1978) (describing CFTC enforcement powers and actions); Jerry W. Markham, *The Seventh Amendment and CFTC Reparations Proceedings*, 68 IOWA L. REV. 87 (1982) (describing CFTC reparations proceedings).

158. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (codified as amended at 15 U.S.C. §§ 78o, 78aaa–78lll (2000)). *See also* sources cited *supra* note 36; Securities Investor Protection Corp. v. Barbour, 421 U.S. 412 (1975) (describing this statute).

159. NYSE firms were choking on daily trading volume averaging 16 million shares at the end of the 1960s. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 361. Today, the NYSE is able to handle daily volume of 2.8 billion shares without a hiccup. Adam Shell, *Have Stocks Finally Hit Bot-*

The statute provided insurance to securities customers (now $500,000, of which up to $100,000 may be in cash) in the event of a broker-dealer insolvency.[160] The CFTCA also directed the CFTC to consider whether such legislation was needed in the futures industry.[161] The resulting CFTC study compared loss ratios of firms under government insurance programs with the loss ratios of commodity futures customers. The loss ratios for futures commission merchant customers were found to be substantially lower than insured firms, leading the CFTC to conclude that insurance was unnecessary.[162]

This is a marked difference in competing regulatory approaches. Insurance creates a moral hazard that the firm being insured will attract funds at low cost from investors on the strength of the government's credit and then use those funds for high return, high risk ventures. The savings and loan debacle of the 1980s is a good example of a gluttonous feast on insured funds.[163] The futures industry, in contrast, uses market discipline to protect customers, which seems an unlikely undertaking when the nature of futures trading is considered. Commodity futures contracts are highly leveraged. The low margin requirements set by the exchanges are only a very small percent of the notional amount at risk.[164] Small moves mean large losses to at least half of the market participants.[165] Futures

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tom?, USA TODAY, July 25, 2002, at 1B. During the "paperwork crisis," some 160 NYSE firms failed, and the exchange exhausted the trust fund it had used to indemnify customers in failed firms. SELIGMAN, *supra* note 32, at 452–53.

160. Securities Investor Protection Act of 1970, 15 U.S.C. § 78fff-3 (2000).

161. Commodity Futures Trading Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (amending 7 U.S.C. §§ 2, 4).

162. Report to the Congress Concerning Commodity Futures Account Insurance, Comm. Fut. L. Rep. (CCH) ¶ 20,235 (Nov. 1, 1976).

163. *See generally* BANKING SCANDALS: THE S & LS AND BCCI (Robert Emmet Long ed., 1993) (describing the looting that went on in the savings and loan industry); Spiegel v. Ryan, 946 F.2d 1435 (9th Cir. 1991), *cert. denied*, 503 U.S. 970 (1992) (describing the looting that went on at Columbia Savings & Loan Association).

164. SEC v. Commodity Options Int'l, Inc., 553 F.2d 628, 629 (9th Cir. 1977).

165. Futures trading is a zero-sum game. For each buyer, there is a seller. A market move one way or the other will mean a gain to one side and a loss to the other. Board of Trade v. CFTC, 724 F. Supp. 548, 555 n.11 (N.D. Ill. 1989). The loss may be offset by another risk, however, as in the case of a hedger. *See* Merrill Lynch, Pierce Fenner & Smith Inc. v. Curran, 456 U.S. 353, n.11 (1982) (describing hedging with commodity futures).

contracts are also selected on the basis of a high degree of price volatility, and speculation is encouraged.[166] Yet, despite the leverage (and attendant risk) and the large element of speculation present, there are fewer customer losses due to the bankruptcy of a financial intermediary than in the insured industries that have less risk, volatility, and speculation.[167]

The answer lies in the way margin trading is regulated in the futures industry. The exchanges set margin for the protection of their clearing houses and positions are marked to market daily. Losses must be recognized through variation margin payments that must be made before the firm can trade the next day. Futures commission merchants are thus forced to recognize customer losses each day. Losses cannot be put off in the hope of a market recovery;[168] nor can they accumulate.[169] The

166. Speculation provides price information and liquidity for hedgers offsetting commercial risks through the futures markets. *Curran*, 456 U.S. at 358–60.

167. From 1970 to at least 1996, no failure of member of a major commodity futures exchange resulted in a loss of customer funds. Jerry W. Markham, *The CFTC Net Capital Rule — Should a More Risk-Based Approach be Adopted?*, 71 CHI.-KENT L. REV. 1091, 1093 (1996) [hereinafter Markham, *The CFTC Net Capital Rule*].

168. As noted by one exchange official:

> This unique feature is a primary factor which enables commodity markets to boast an incredibly good record in the area of insolvencies. Every firm must be monetarily "even" with the commodity prices of the previous day. If a firm's net commitment shows a net loss on the basis of the previous settlement prices, it pays the resultant amount to the exchange clearinghouse. If a firm's net commitment shows a profit, it collects the resultant amount from the clearinghouse. This process is a daily procedure.

Review of the Commodity Exchange Act and Discussion of Possible Changes: Hearings Before the House Comm. on Agriculture, 93d Cong. 192 (1973) (statement of Leo Melamed, Secretary of the Board, Chicago Mercantile Exchange).

169. This is not to say that there have been no failures of futures commission merchants. Large customer losses have occurred as the result of looting of customer accounts to pay margins for accounts in deficit. Three of the more highly publicized of those failures occurred in the early 1980s: Incomco, Inc.; Chicago Discount Commodity Brokers; and Volume Investors. The latter failure led the CFTC staff to reconsider whether account insurance was needed, but no action was taken. At the time, customer losses from bankrupt futures commission merchants were averaging only about $2 million per year. 23 MARKHAM & HAZEN, *supra* note 35, § 4.08. The tenth largest futures commission merchant failed in 1990. *See* In re Stotler & Co., 144 B.R. 385, 386 (N.D

securities industry, on the other hand, had no comparable market discipline. Transactions were settled on a T+5 basis, i.e., settlement was not made until five days after the execution of the trade. This left plenty of time for losses to mount or for customers to engage in reckless conduct to make up for losses. The SEC has since imposed a T+3 requirement on settlement, but this is still three days more than is required in the futures industry.[170]

At the time the CFTC was created, the SEC was also in the midst of defending an expansive interpretation of its insider trading program under Rule 10b-5. The CFTC later conducted a study to determine whether a similar rule was needed in the futures industry,[171] but concluded it was not appropriate to impose such a regulation on futures traders.[172] Many participants in the futures markets had superior access to information and traders on exchange floors had time and place advantages for the use of information. The CFTC believed that it was neither

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Ill. 1992) (describing size of bankruptcy). That firm, Stotler & Co., was headed by the Chairman of the Chicago Board of Trade. The parent company had moved several millions of dollars out of the futures commission merchant before it failed. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 162–63. Customer losses, however, appear to have been minimal. *See In re Stotler*, 144 B.R. at 386.

170. *See generally* Report of the Backmann Task Force on Clearance and Settlement Reform in U.S. Securities Markets, Exchange Act Release No. 30,802, 51 S.E.C. Docket 1,073 (June 15, 1992) (describing need for reducing settlement period); Securities Transactions Settlement, Exchange Act Release No. 34-33,023, 58 Fed. Reg. 52,891 (Oct. 13, 1993) (adopting T+3 requirement). An SEC chairman subsequently suggested that T+1 or even same day settlement should be the securities industry goal. SEC Chairman Arthur Levitt, *Speeding Up Settlement; The Next Frontier*, Address Before a Symposium on Risk Reduction and Payments, Clearance and Settlement Systems, New York, NY, Jan. 26, 1996.

171. CFTC, *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material Nonpublic Information, submitted to the House Committee on Agriculture and Senate Committee on Agriculture, Nutrition and Forestry Pursuant to Section 23(b) of the Commodity Exchange Act, as Amended* (Sept. 1984) (on file with author) [hereinafter CFTC, *Study of the Nature, Extent and Effects of Futures Trading*].

172. *Id.* The author leaves for others to resolve the debate whether insider trading in securities is good or bad. *See* Henry G. Manne, *Options? Nah. Try Insider Trading*, WALL ST. J., Aug. 2, 2002, at A8 (advocating using inside information as a form of compensation and asserting that: "Currently, the SEC sees its job as regulating the entire market for information. This is madness.").

practical nor desirable to mandate that traders have equal access to information, as required by the SEC.[173]

The CFTC did seek to adopt some regulatory requirements that would have more closely conformed its regulatory structure to that of the SEC, largely due to the fact that several newly arrived staff members at the CFTC had formerly served on the SEC staff.[174] One SEC-style proposal enacted was a net capital rule.[175] The SEC had adopted its Uniform Net Capital Rule in the aftermath of the paperwork crisis.[176] Since the stock exchanges had failed to enforce their capital rules during the paperwork crisis,[177] the SEC concluded that a more stringent federal rule was needed to protect customers and the SIPA insur-

173. The CFTC viewed most information used for futures trading to be "market" information that, at least in theory, was accessible to everyone, even if not on an equal basis. The CFTC did express concern regarding abuses of information obtained by the exchanges in confidence that could be traded for a profit. The CFTC adopted a rule to guard against such abuses (17 C.F.R. § 1.59 (2002)), and the Commodity Exchange Act was later amended to include such a prohibition. *See* H.R. REP. NO. 102–978, at 23 (1992) (discussing the amendment). The CFTC initially rejected the "misappropriation" theory that the SEC was pushing in the securities industry. *Compare*, CFTC, *Study of the Nature, Extent and Effects of Futures Trading*, *supra* note 171, at 57, *with*, United States v. O'Hagan, 521 U.S. 642 (1997) (endorsing SEC misappropriation theory). The CFTC, however, later brought a case against two traders who were misappropriating information concerning the trading plans of a large firm that had market effect. Commodity Futures Trading Comm'n v. Kelly, Comm. Fut. L. Rep. (CCH) ¶ 27,465 (S.D.N.Y. 1998).

174. *See* MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 86 (describing staff members that drafted CFTC net capital rule). (The author must confess to being one of these staff members.)

175. Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers, 17 C.F.R. § 1.17 (2002).

176. Net Capital Requirements for Brokers and Dealers, 17 C.F.R. § 240.15c3-1 (2002). Government insurance programs inevitably lead to pervasive and intrusive, as well as very expensive and complex, regulation — all of which is justified as necessary to protect the insurance fund because market discipline has been removed.

177. The Chairman of the NYSE stated that another one hundred exchange member firms would have been put out of business if the exchange had strictly enforced its capital rule during the paperwork crisis. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 364. In contrast, the Chicago Board of Trade suspended the firm of Hayden, Stone for failing to meet its capital requirements. The NYSE then pressured the Board of Trade to remove the suspension in order to prevent a failure of the firm, which was also a member of the NYSE. Hayden, Stone continued to encounter difficulties. *Id.* at 363.

ance fund.[178] The futures industry had no paperwork crisis — its overnight settlement requirement and paperless trading assured that result.[179] Nevertheless, the newly arrived SEC staff members were fresh from their exposure to the SEC Uniform Net Capital Rule, and believed such a requirement was needed.[180] Still, the CFTC net capital rule does not appear to have had much effect in preventing insolvencies by futures commission merchants. If anything, the traditionally low rate of failures actually increased.[181] The CFTC net capital rule is also flawed and out of date in its risk measurement criteria,[182] but still remains on the books.

The CFTC staff also tried to borrow wholesale from the SEC's rulebook[183] by proposing a set of customer protection rules.[184]

178. The SEC's capital rule did not apply to exchange member firms until the adoption of its Uniform Net Capital Rule in 1975. Under the old rule, stock exchange member firms were subject to capital requirements imposed by the exchanges. 23A MARKHAM & HAZEN, *supra* note 35, § 5.02. For a description of the background and reasons for the adoption of the Uniform Net Capital Rule, see generally SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKER-DEALERS, H.R. DOC. NO. 92-231 (1971).

179. In 1968, Congress added the authority to adopt capital rules to the Commodity Exchange Act of 1936 due to concern that irresponsible firms were entering the business. Commodities Exchange Act of 1936, amended by 82 Stat. 26 (1968). *See generally* S. REP. NO. 90-947 (1968), *reprinted in* 1968 U.S.C.C.A.N. 1673.

180. *See generally* Proposed Financial Reporting Requirements for Futures Commission Merchants, Comm. Fut. L. Rep. (CCH) ¶ 20,220 (Oct. 15, 1976) (describing proposed CFTC net capital rule).

181. *See supra* note 169 (describing failures by futures commission merchants on the CFTC's watch).

182. *See* Markham, *The CFTC Net Capital Rule*, *supra* note 167, at 1091 (describing flaws in CFTC net capital rule).

183. Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers, 17 C.F.R. § 1.17 (2002). There has been some cross-fertilization from the CFTC to the SEC. As another measure to protect the SIPA insurance fund, the SEC was directed by Congress to adopt rules for the protection of customer funds. 15 U.S.C. § 78o(c)(3)(A) (2000). The SEC adopted its "Customer Protection Rule" in response. 17 C.F.R. § 240.15c3-3 (2002). This rule requires customer funds held by broker-dealers to be kept in special bank accounts held for the benefit of customers. Box counts of customer funds and securities are also required. *Id.* The rule was adopted in the wake of the paperwork crisis and after criticism was raised that customer free credit balances were being used to fund the operations of broker-dealers, effectively an interest-free loan. 23A MARKHAM & HAZEN, *supra* note 35, § 4.03. The SEC Customer Protection Rule was directly analogous to the requirement in the Commodity Exchange Act of 1936 on segregation of customer funds and

Among other things, the proposals included a rule imposing a supervision requirement like that employed by the SEC. The rule was adopted, albeit in a more simplified form.[185] A proposal to adopt a suitability requirement did not fare as well[186] — it set off a firestorm of controversy and the rule was never adopted.[187] Instead, the CFTC adopted a one-page risk disclosure statement that advised customers of the risks of trading commodity futures, and recommended that customers should themselves consider whether commodity futures trading was suitable in light of their particular circumstances and financial resources.[188] Customers were required to sign the statement and

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securities into special bank accounts. 7 U.S.C. § 6d (2000). *See also* Customer Funds to be Segregated and Separately Accounted For, 17 C.F.R. § 1.20 (2002) (regulation implementing segregation requirements).

The SEC stated that it was hopeful that its Customer Protection Rule would obviate the need for its net capital rule. SECURITIES EXCHANGE COMMISSION, STUDY ON THE FINANCING AND REGULATORY CAPITAL NEEDS OF THE SECURITIES INDUSTRY 7 n.17 (Jan. 23, 1985) (on file with author). Government being what it is, that never came to pass.

184. *See generally* Protection of Commodity Customers: Standards of Conduct for Commodity Trading Professionals, 42 Fed. Reg. 44,742 (1977).

185. 17 C.F.R. § 166.3 (2002). *See generally* Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886 (1978). (As the result of much industry opposition, the proposed supervisory rule was simplified before adoption.)

186. Protection of Commodity Customers: Standards of Conduct for Commodity Trading Professionals, 42 Fed. Reg. 44,742, 44,743 (1977).

187. The CFTC asserted that such a requirement was implied in the Commodity Exchange Act of 1936, and, therefore, a rule was not needed. Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886, 31,889 (1978). After some flip-flopping, the CFTC later held in its reparations proceedings that there is no suitability requirement in the act. Phacelli v. Conticommodity Services, Inc., Comm. Fut. L. Rep. (CCH) ¶ 22,345 (C.F.T.C. 1984). The courts agreed with that interpretation. *See, e.g.*, Schofield v. First Commodity Corp., 793 F.2d 28 (1st Cir. 1986).

The CFTC had also proposed a churning rule that would have prohibited brokers from excessively trading customer accounts they controlled. Protection of Commodity Customers: Standards of Conduct for Commodity Trading Professionals, 42 Fed. Reg. 44,742, 44,745 (1977). This proposal was also dropped. Like the suitability proposal, the CFTC claimed that such a requirement was already implied in the Commodity Exchange Act of 1936. Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886, 31,889 (1978). Unlike the suitability rule, the CFTC later held that the CEA antifraud provision implied a churning prohibition. *See, e.g.*, In re Lincolnwood Commodities, Inc., Comm. Fut. L. Rep. (CCH) ¶ 21,986 (C.F.T.C. 1984).

188. Distribution of "Risk Disclosure Statement" by Futures Commission Merchants and Introducing Brokers, 17 C.F.R. § 1.55 (2002).

confirm that they had read and understood the risks.[189] This was visibly different from the paternalistic approach of the SEC — the CFTC was requiring individuals to take responsibility for their own investment decisions. Regulatory competition was indeed influencing the manner in which the two industries would be regulated. This competition would also lead to much strife.

IV. REGULATORY BATTLES BETWEEN CFTC AND SEC

The SEC was not new to regulatory competition when the CFTC arrived, and had just recently engaged in an extended quarrel with the banking regulators over which it should have been given authority to regulate securities clearing and settlement functions conducted by banks.[190] That slanging match ended in a compromise whereby regulatory authority over banks engaging in clearing and settlement was given to the bank regulatory authorities, while the SEC regulated all others.[191] In another act of aggression, the SEC adopted a rule that would have subjected banks engaging in securities activities to registration as broker-dealers under the Securities Exchange Act of 1934. However, a circuit court struck down the rule as being outside the SEC's jurisdiction.[192] Nonetheless, the SEC continued to seek to regulate banks through the back door of disclosure, i.e., most large banks are public companies that must report to the SEC.[193]

The SEC soon found itself on the defensive as bank regulators took an increasingly liberal view of which activities banks could

189. *Id.*

190. The SEC claimed before Congress that it had greater enforcement powers than the bank regulators and thus should be given sole jurisdiction over all clearing and settlement activities, including those by banks. The banks took umbrage and fought back in Congress with their own expansive claims of regulatory authority. *See* 23A MARKHAM & HAZEN, *supra* note 35, § 8.02.

191. *Id.* A similar compromise was reached in 1985 over the regulation of dealers in government securities. 3 HAZEN TREATISE, *supra* note 51, § 14.7 (describing Government Securities Act of 1986).

192. American Bankers Ass'n v. SEC, 804 F.2d 739 (D.C. Cir. 1986).

193. Raphael Soifer, *U.S. Regulator Applies the Pressure*, 151 BANKER, Issue No. 902, Apr. 1, 2001.

engage in under the Glass-Steagall Act.[194] The securities industry retaliated through the courts, with mixed success. Furthermore, competition between the CFTC and the SEC was another challenge that began almost immediately after the adoption of the CFTCA. The decision of the CFTC to approve commodity futures trading on Government National Mortgage Association ("GNMA") certificates set off an explosion at the SEC. The SEC contended that such contracts were the equivalent of "when issued" GNMAs that were already regulated by the SEC. This resulted in an exchange of acrimonious correspondence between the two agencies. At the end of the day, the SEC lost the battle and GNMA futures continued to trade.[195] Undaunted, the CFTC also approved a futures contract on treasury bills on the Chicago Mercantile Exchange in 1976.[196] The SEC, however, had a long memory and, as will be seen, would retaliate against the CFTC.[197]

In the meantime, the grant of exclusive jurisdiction to the CFTC over commodity options[198] removed the regulatory controls established by the SEC and state securities administrators over commodity option dealers.[199] The results were a quick return of fly-by-night commodity option firms, numerous scandals, and widespread fraud. The situation was not alleviated until the CFTC suspended the trading of commodity options,[200]

194. *See generally* MICHAEL G. CAPATIDES, A GUIDE TO THE CAPITAL MARKETS ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES (1993) (describing expansion of bank activities).

195. *See* MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 81–83 (describing this dispute).

196. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 81.

197. *See infra* note 208 and accompanying text.

198. Commodity Exchange Act, 7 U.S.C. § 2a(ii) (2000).

199. *See* John M. Schobel, Jr. & Jerry W. Markham, *Commodity Options — A New Industry or Another Debacle?*, Sec. Reg. & L. Rep. (BNA) 1–20 (Special Supp. Apr. 7, 1976) (describing return of fly-by-night commodity options firms).

200. 17 C.F.R. § 32.11 (1978). Several of these firms grew quickly and were selling options on a national basis to unsophisticated customers; fraud was widespread. The CFTC also discovered that one of the larger of these firms was owned and operated by a felon who had escaped from prison. Kelley v. Carr, 567 F. Supp. 831 (W.D. Mich. 1983). At the time it suspended options trading, the CFTC was devoting a large amount of its resources to options problems. *See Extend Commodity Exchange Act: Hearings on H.R. 10285 Before the House Subcomm. On Conservation and Credit of the House Comm. on Agriculture*, 95th Cong. 39 (1978) (statement of William Bagley, CFTC

but the SEC used the scandals as the basis for an unsuccessful attempt to wrest jurisdiction from the CFTC during the latter's reauthorization hearings in 1978,[201] seeking regulatory authority on all instruments involving securities. The Treasury Department also desired a role where treasury securities were involved. Congress, however, refused to entertain these demands and merely directed the CFTC to consult with the SEC and the banking regulators where instruments they regulated were the subject of commodity futures or options trading.[202]

Another threat to the SEC was the decision by the CFTC to approve futures trading on stock indexes.[203] These contracts were almost immediately popular and spread to other commodity exchanges. The SEC retaliated by approving the trading of options on GNMA certificates on the CBOE. The commodity exchanges challenged this action in court and won before the Seventh Circuit.[204] By this point, the SEC realized that it was fighting a losing battle in trying to encroach on the CFTC's ju-

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Chairman, describing resources expended by CFTC on options problems). The CFTC allowed some options trading to continue, including options entered into by commercial firms. Exemptions, 17 C.F.R. § 32.4 (2002). The CFTC also later allowed commodity options trading to be conducted on commodity exchanges, which provided a regulatory structure for excluding the fly-by-night firms that led to the retail over-the-counter options suspension. Regulation of Domestic Exchange-Traded Commodity Options, 46 Fed. Reg. 54,500 (1981).

201. *See* MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 99–100 (describing jurisdictional fight). The SEC had regulatory problems of its own with respect to exchange traded stock options. As the result of abuses, the SEC suspended further expansion of such trading and conducted an extended study of the stock options market. After some reforms, the SEC allowed trading to continue. *See generally* REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS TO THE SEC. AND EXCH. COMM'N, 96TH CONG. (Comm. Print 1978) (describing abuses).

202. MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 99–100

203. The Kansas City Board of Trade inaugurated the trading of index futures in 1982. Chicago Board of Options Exch., Inc. v. Board of Trade, 459 U.S. 1026 (1982); Board of Trade v. SEC, 677 F.2d 1137, 1171 n.11 (7th Cir.), *vacated as moot sub. nom*. *See also* Standard & Poor's Corp. v. Commodity Exch. Inc., 683 F.2d 704 (2d Cir. 1982) (describing stock index futures); Jerry W. Markham & David J. Gilberg, *Washington Watch — Stock Index Futures*, 6 CORP. L. REV. 59 (1982) (same).

204. Chicago Board Options Exchange, Inc. v. Board of Trade, 459 U.S. 1026 (1982); Board of Trade v. SEC, 677 F.2d 1137 (7th Cir.), *vacated as moot sub. nom.*

risdiction; it had learned that it could not win a confrontation in Congress over this matter. The futures industry lobby was simply too strong, and the agricultural committees were captive of those interests. The natural result was to establish an administrative démarche: an agreement was hammered out between the Chairmen of the SEC and CFTC (the "Shad-Johnson Accords"), which allocated jurisdiction between their two agencies.[205] Thereafter, Congress enacted the Shad-Johnson Accords into law.[206] In brief, the CFTC was given exclusive jurisdiction over all commodity futures trading on any instrument, except that single stock futures were prohibited, joining onions as the only commodity on which futures trading was banned.[207] The SEC was given what amounted to a veto over commodity futures contracts on indexes,[208] and retained jurisdiction over options trading on the stock exchanges, including options on indexes.[209] The SEC and CFTC shared jurisdiction over options trading on foreign currency.[210]

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205. CFTC and SEC Jurisdictional Agreement: Proposed Legislation, Comm. Fut. L. Rep. (CCH) ¶ 21,332 (Feb. 2, 1982).

206. Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (codified in scattered sections of 7 U.S.C.).

207. 7 U.S.C. § 2 (2000).

208. *See generally* Don L. Horwitz & Jerry W. Markham, *Sunset on the Commodity Futures Trading Commission: Scene II*, 39 BUS. LAW. 67, 73–74 (1983) (describing scope of Shad-Johnson Accords and veto authority of SEC on indexes). This veto authority led to another dispute with the CFTC that was temporarily resolved by another inter-agency agreement. Edward J. Kane, *Regulatory Structure in Futures Markets: Jurisdictional Competition Between the SEC, the CFTC, and Other Agencies*, 4 J. FUT. MARKETS 367, 375 (1984). Several years later, the SEC approved options trading on two Dow Jones indexes and then used its veto power to deny trading of commodity futures on those same indexes. The Seventh Circuit set that incredible bit of regulatory chutzpah aside. Board of Trade v. SEC, 187 F.3d 713 (7th Cir. 1999).

209. The CFTC could not approve options on stock indexes, but it was allowed by the Shad-Johnson Accords to approve options on futures on indexes. Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (codified in scattered sections of 7 U.S.C.).

210. The SEC had jurisdiction where options on currency were traded on the stock exchanges. The CFTC had jurisdiction over options trading on commodity exchanges and the over-the-counter market. Trading in the over-the counter market in currency options would plague the CFTC over the next several years. *See* 13A MARKHAM, FRAUD, MANIPULATION & OTHER CLAIMS, *supra* note 124, § 27:13 (describing cases brought by CFTC against over-the-counter currency dealers).

This cooperative allocation of jurisdiction did not mask the fact that there were two very distinct regulatory cultures at the CFTC and SEC. The CEA, the predecessor to the CFTC, was largely driven by economists; the agency had only one lawyer on staff. The CFTC inherited the CEA's personnel, and most of the former SEC staff members, who were recruited when the CFTC was first formed, quickly departed. The economists at the CFTC, however, were willing to defer to the exchanges and had an antipathy towards a heavily rule-based regulatory structure. The occasional activist-lawyer chairman at the CFTC was unable to change that culture. As a result, the futures industry was allowed to develop essentially on its own.[211] In contrast, the SEC maintained an activist culture driven by lawyers who believed fervently in regulation. The SEC was quite willing to direct the development of the market, having lost confidence in the industry to do so as a result of the paperwork crisis.[212] The central market concept was apace with that view.[213] The SEC was intrusive in its regulation of the exchanges and broker-dealers, and was forever seeking to expand its jurisdiction.[214]

When given the opportunity, traders often voted with their feet in assessing the relative efficiency of the commodity futures and stock exchanges. Stock index futures fit neatly into the

211. The CFTC staff did believe strongly that the Commodity Exchange Act created a monopoly that required futures, and later options, to be traded on a contract market licensed by the CFTC. *See generally* Markham, *The Commodity Exchange Monopoly, supra* note 128 (describing CFTC support for the exchange trading requirement).

212. *See supra* notes 159, 176–79 and accompanying text.

213. *See supra* note 44 and accompanying text.

214. In fairness to the SEC, it was deregulating some important aspects of the market, i.e., institutional investors, by exempting sales to "accredited investors" from the registration requirements of the Securities Act of 1933. *Compare* Jerry W. Markham, *Protecting the Institutional Investor — Jungle Predator or Shorn Lamb?,* 12 YALE J. ON REG. 345 (1995) (describing regulatory structure for institutional investors and urging even less regulation), *with*, Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 B.Y.U. L. REV. 1493 (seeking greater regulation to protect institutional investors). Integrated disclosure and shelf registration were also useful in allowing capital raising to be carried out more efficiently. *See generally* Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985) (describing SEC disclosure system).

modern portfolio theory of a diversified portfolio.[215] Program trading, dynamic hedging, and index arbitrage offered additional opportunities for the adroit trader.[216] Futures trading on indexes and interest rate instruments soon outstripped volume on the more traditional agriculture futures contracts.[217] Futures contracts were efficient and presented low costs to traders, who did not need to buy and sell the stock underlying the index in order to profit from, or hedge against, fluctuations. This avoided the transaction costs associated with buying and selling the underlying securities.[218] Low margins and liquidity also made stock futures extremely popular with institutional investors, while interest rate futures were of equal or greater interest to portfolio managers with investments in fixed income securities. The stock markets and futures markets soon became intermingled and interdependent with this trading. The danger

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215. *See generally* ROBERT L. HAGIN, THE DOW-JONES IRWIN GUIDE TO MODERN PORTFOLIO THEORY (1979); JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY (2d ed. 1998) .

216. *See generally* Jerry W. Markham & Rita McCloy Stephanz, *The Stock Market Crash of 1987 — The United States Looks at New Recommendations*, 76 GEO. L. J. 1993, 1999–2001 (1988) (describing these concepts).

217. Between 1983 and 1994, the volume in financial futures increased from 40% of all futures contracts traded to 83%. By 1994, financial futures accounted for 97% of the trading volume on the Chicago Mercantile Exchange. Steven C. Livingston, *Rift Grows Between Factions at CBOT*, WALL ST. J., Sept. 26, 1994, at C1.

218. For example, assume that the manager of a portfolio that tracks the S&P 500 stock index believes that the market will be falling over the next three months. The manager could sell out the portfolio and buy it back in when he anticipates recovery. Alternatively, the manager could passively invest and do nothing, a popular strategy but one that assumes a market recovery before the portfolio funds are needed. Alternatively, the manager could hedge by selling the S&P 500 futures contract. The only cost is commissions, which can be negotiated to a minimal level. This locks in the value of the portfolio in the event of a market decline. Of course, the portfolio value is also locked in if the portfolio manager was wrong. For those interested, and many were, stock baskets matching the S&P 500 and other indexes could be purchased through the stock markets. This, of course, required payment for the full value of the stocks in the basket or 50% margin, as compared to the 5% or less that had to be placed only as security for index futures trading. *See generally* SEC DIVISION OF MARKET REGULATION, THE ROLE OF INDEX-RELATED TRADING IN THE MARKET DECLINE ON SEPTEMBER 11 AND 12, 1986 (1987) (describing use of stock index baskets to facilitate arbitrage trading).

of this interdependence was brought dramatically home in the stock market crash of 1987.[219]

The stock and commodity markets experienced a near meltdown during the stock market crash that occurred in October 1987. The decline was the largest ever experienced to that date, exceeding even the 1929 crash.[220] Numerous regulatory reports resulted from that event.[221] A Presidential commission headed by later Secretary of the Treasury Nicholas Brady (the "Brady Commission") concluded that the securities and commodity futures markets had become intertwined and that a lack of coordinated regulation between the SEC and CFTC was endangering the markets.[222] The Brady Commission recommended a regulatory restructuring whereby a single agency would be authorized to regulate such matters as margin and credit and information systems.[223]

The Brady Commission recommendations and the fallout from the stock market crash of 1987 set off another turf war between the CFTC and the SEC. Even so, the SEC's report on the market crash made some startling admissions, including a concession that the futures markets were popular because they were more efficient than the securities markets and were even

219. Even before the crash, the NYSE was warning of a danger of a "meltdown" in the stock markets caused by futures trading in indexes. Martin Mayer, *Some Watchdog! How the SEC Helped Set the Stage for Black Monday*, BARRON'S, Dec. 27, 1987, at 18.

220. Comparisons were drawn between the stock market crashes in 1929 and 1987, suggesting the possibility of another depression. Randall Smith, *Market Seers Fret over Analogies to '29-'30, Despite Economic Vigor*, WALL ST. J., Mar. 31, 1988, at 25. Fortunately, that did not occur. The market also faced even larger drops in subsequent years. *See, e.g., Gloomy Return: U.S. Stocks Plummet As Trading Resumes Without Major Hitch*, WALL ST. J., Sept. 18, 2001, at A1 (describing record drop after trading resumed following September 11, 2001 terrorist attacks on the World Trade Center and the Pentagon).

221. *See* Markham & Stephanz, *supra* note 216, at 2006–21 (describing these reports).

222. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS, *reprinted in* Fed. Sec. L. Rep. (CCH) Special Report No. 1267 (Jan. 12, 1988) (report by the Brady Commission).

223. The Brady Commission recommended the Federal Reserve Board as the agency to serve as a super regulator. *Id*. at 42.

leading the stock exchanges in setting prices.[224] The SEC was concerned, however, that market volatility had increased significantly as a result of futures trading on securities due to low margins in the futures industry.[225] This reflected another cultural regulatory difference between the SEC and CFTC. Volatility is an accepted, indeed required, part of the futures markets. Futures are not needed for commodities with stable prices. Such commodities do not need the benefits of hedging, and speculators are uninterested because there is no profit to be made from a stable price.

In contrast, the SEC has a constituency of small investors that are content with stable prices — they invest in dividend stocks in such cases — and love for prices to go higher. These small investors do, however, loathe a drop in prices. When that happens, the small investors' capital is reduced, which they find intolerable. Complaints are made to the SEC and to Congress, demanding protection from such events — a drop in prices or a loss on an investment requires a bogeyman; someone must be punished. The SEC's regulations reflect this bias, as evidenced by its "tick test" for short sales.[226] (There is no such test for long traders.) In contrast, the CFTC has no tick test; rather, the commodity futures exchanges use price limits — now called "circuit breakers" — to halt trading when prices move up *or* down in specified amounts. This gives traders an opportunity to assess market conditions and obtain margin funds.[227] There is no long or short bias in these limits.

The Brady Commission believed that margin requirements should be harmonized across markets, a recommendation that the SEC joined.[228] They were undercut somewhat by an earlier

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224. The tail was indeed wagging the dog. *See* SEC DIVISION OF MARKET REGULATION, THE OCTOBER 1987 MARKET BREAK 3-6 (1988) (finding that commodity futures exchanges were leading the stock exchanges in pricing).

225. *See id*. at 3-7 to 3-8 (describing how the futures markets have increased stock market volatility).

226. Short Sales, 17 C.F.R. § 240.10a-1 (2002). *See generally* David C. Worley, *The Regulation of Short Sales: The Long and Short of It*, 55 BROOK. L. REV. 1255 (1990).

227. *See* Markham & Stephanz, *supra* note 216, at 2034–35 (describing price limits and noting that they were first used by the commodity exchanges before World War I).

228. *See* Markham, *Federal Regulation of Margin*, *supra* note 114, at 118 (describing SEC and Brady Commission advocacy of higher margins).

Federal Reserve Board study, which had concluded that even margin requirements on stocks were no longer serving the purposes originally intended by Congress.[229] The SEC again lost the battle,[230] and the only substantive regulation to emerge from the stock market crash of 1987 was the introduction of circuit breakers that halted trading when large market moves occurred. Even this regulation was mostly abandoned in later years because traders did not like these restraints.[231]

But another game had arrived for the CFTC and SEC to scrimmage over. Financial engineering had become an accepted science with the development of numerous new instruments having characteristics of both futures and options.[232] The swap contract was one such product; its popularity was almost instantaneous and it soon became a substantive part of corporate

229. A REVIEW AND EVALUATION OF FEDERAL MARGIN REGULATIONS: A STUDY BY THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Dec. 1984) (on file with author). The Fed later adopted margin requirements based on good faith loan value for many non-equity securities, which essentially meant that credit could be extended to the purchaser in amount equal to what the lender thought the securities were worth to secure the loan. 63 Fed. Reg. 2806, 2811–13 (Jan. 16, 1998). The Fed at one point did express a desire to have uniform margins for futures and options, but believed the purpose of such margins should be clearing house protection and not to regulate speculation. *See* Markham, *Federal Regulation of Margin*, *supra* note 114, at 110, 112, 122 (describing Fed's views on margin).

230. *See* Markham, *Federal Regulation of Margin*, *supra* note 114, at 119–24 (describing margin fight led by SEC in the Working Group on Financial Markets created by President Reagan to address the concerns raised by the Brady Commission report). In a bit of silliness, Congress did grant the power to set margins on stock indexes to the Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590, 3629 (codified in scattered sections of 15 U.S.C.). The Fed ceded that authority to the CFTC, which in turn relinquished it to the commodity exchanges — precisely where the authority had started. *See* Markham, *The CFTC Net Capital Rule*, *supra* note 167, at 1093 n.12 (describing delegation of this authority).

231. *See* Andrew Hill & John Labate, *Assault on American Finance*, FIN. TIMES (London), Sept. 17, 2001, at 5 (describing history of circuit breakers and their widening).

232. The Seventh Circuit held that the SEC had improperly approved the trading of so-called "index participation" contracts ("IPs") on the CBOE and that these contracts fell within the exclusive jurisdiction of the CFTC. Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989), *cert. denied sub nom.*, Investment Company Institute v. SEC, 496 U.S. 936 (1990).

finance.[233] The CFTC awakened only slowly to this threat, but eventually responded by seeking to curb the growth of over-the-counter commodity-related instruments.[234] It adopted regulations that created an inscrutable formula for determining whether particular instruments would be required to trade only on a commodity exchange.[235] This effort proved to be less than successful, and the CFTC was left to struggle with a growing list of derivative instruments that were being introduced in the market.

In the early 1990s significant losses were encountered by a number of large institutions — Gibson Greeting and Procter & Gamble suffered tremendously; Orange County in California and the Barings Bank went bankrupt, to name just a few.[236] These losses touched off another round of handwringing at the SEC and more studies.[237] Still, nothing was done, except that the SEC brought a case claiming that certain of these instruments were securities,[238] and the CFTC brought another case claiming that other instruments were futures that had to be traded on a contract market.[239] A furor ensued, and both agencies' rulings were undercut by court decisions.[240] The SEC then

233. *See generally* Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance Into the Abyss?,* 43 AM. U. L. REV. 1023 (1994) (describing swaps).

234. *See generally* Jerry W. Markham, *Regulation of Hybrid Instruments Under the Commodity Exchange Act — Alternatives Are Needed*, 1990 COLUM. BUS. L. REV. 1 (1990) (describing the development of over-the-counter derivatives).

235. Under these rules, unless otherwise regulated, if the instrument's commodity futures or options element outweighed its securities characteristics, it had to be traded on a commodity futures exchange. Regulation of Hybrid Instruments, 17 C.F.R. §§ 34.1–34.3 (2002).

236. *See* Jerry W. Markham, *"Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments*, 25 SETON HALL L. REV. 1, 28–31 (1994) (cataloguing losses).

237. *Id.* at 32–40 (describing the reports).

238. In re BT Securities, 52 S.E.C. 109, 113–15 (1994) (consent order).

239. In re BT Securities, CFTC Doc. No. 95-3, at 95-4 (C.F.T.C. 1994) (consent order). *See also* In re M.G. Refining & Marketing, Inc., CFTC Doc. No. 95-14 (C.F.T.C. 1995) (illegal over-the-counter trading in a futures product).

240. Thereafter, the SEC exempted dealers from registration as broker-dealers if they engaged in such activities. To the extent government securities were involved, they were exempt securities. 23A MARKHAM & HAZEN, *supra* note 35, § 14.9. A district court also held that contracts similar to those claimed to be securities by the SEC were not such. Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1274 (S.D. Ohio 1996). *But see* Caiola

proceeded to create a safe harbor from onerous regulation through so-called "Broker-Dealer Lite" registration.[241] The CFTC viewed this as a threat to its jurisdiction and announced a plan to conduct an investigation of over-the-counter derivatives to determine whether they should be regulated, though the industry viewed this as no more than a cover to lay the groundwork for such regulation. The SEC, the Treasury Department, and the Federal Reserve Board all weighed in against such a jurisdictional grab. In the end, Congress responded with legislation that stopped the CFTC.[242] Yet all of this commotion was for naught — as of the beginning of 2000, only one firm had registered as a Broker-Dealer Lite.[243]

V. MARKET STRUCTURE CHANGES

The financial services sectors were undergoing sweeping changes while the SEC and CFTC competed with each other in their regulatory programs. Banks were increasing their penetration of the securities industry through "Section 20" subsidiaries that could engage in limited dealing in securities.[244] The

v. Citibank, N.A., 295 F.3d 312 (2d Cir. 2002) (disagreeing with analysis of the court in *Procter & Gamble*).

The CFTC had to back off its expansive ruling. *C.F.T.C. Says Ruling Didn't Expand Scope*, N.Y. TIMES, Jan. 23, 1996, at D4. *See also* In re MG Ref. & Mktg. Litig., Comm. Fut. L. Rep. (CCH) ¶ 26,956 (S.D.N.Y. 1997) (CFTC consent decree was not binding as collateral estoppel). *See generally* Alton B. Harris, *The CFTC and Derivative Products; Purposeful Ambiguity and Jurisdictional Reach*, 71 CHI.-KENT L. REV. 117 (1996) (describing the CFTC and SEC cases against BT Securities).

241. 17 C.F.R. § 240.3b-13 (2002). Broker-Dealer Lite is a regulatory structure created by the SEC in 1998. It gives securities firms the option to establish OTC dealer affiliates ("OTC Derivatives Dealers") that operate under lower net capital requirements and less stringent margin rules than are applicable to other broker-dealers. *See generally* OTC Derivatives Dealers, Release No. 34-40,594, 63 Fed. Reg. 59, 362 (Nov. 3, 1998).

242. *See* 23 MARKHAM & HAZEN, *supra* note 35, § 2.09 (describing this regulatory dust-up).

243. *Id.* § 2.10.

244. Banks were allowed to acquire discount brokers. *See* Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Sys., 468 U.S. 207 (1984). The Fed also allowed bank subsidiaries to engage up to 5% of their business in otherwise ineligible securities under the Glass-Steagall Act. *See* Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Sys., 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1989). The limitation was subsequently increased first to 10%, and later to 25%, which was sufficient to allow banks to own large full service

bank regulators continued to drop barriers to bank entry into the commodity futures and options business,[245] and insurance became a popular bank product.[246] Finally, the GLBA freed the banks of most of the remaining Glass-Steagall restrictions on their financial services activities.[247]

In the meantime, the world of derivatives and securities trading had changed. Over-the-counter instruments, such as swaps, caps, collars and floors, were an increasingly popular alternative to exchange-traded commodity futures and options. Competition from abroad was also posing a major threat to the dominance of the American futures and options markets. The commodity exchanges in America had long ruled the futures markets, but the largest futures exchange in the world at the end of the twentieth century was Eurex, a German exchange.[248] How did this come to pass? Foreign exchanges had undercut the American markets mostly through electronic trading. The monopoly given to the contract markets by the Commodity Exchange Act of 1936 had created an industry tied to the trading floors. The floor members controlled the exchanges and were loathe to give up the time and place advantage on the floor to an electronic forum where everyone has equal access.[249] Members' capital was at risk, so they would cling to this franchise as

broker-dealers. Revenue Limit on Bank-ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750, 68, 751 (Dec. 30, 1996).

245. The leading derivatives dealers in 1993 were mostly banks. Markham, *Banking Regulation: Its History and Future, supra* note 4, at 259.

246. Broome & Markham, *supra* note 19, at 763–64.

247. Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 U.S.C.).

248. Adding to the embarrassment from this loss of position was the fact that Germany had barred futures trading until the end of the 1980s. William P. Rogers & Jerry W. Markham, *The Application of West German Statutes to United States Commodity Futures Contracts: An Unnecessary Clash of Policies*, 19 L. & POL'Y INT'L BUS. 273 (1987). Volume is still high on American exchanges, but Eurex is the leader. Christopher Bowe, *Survey — World Stock and Derivative Exchanges*, FIN. TIMES (London), June 6, 2002, at 4. Commodity exchanges in the U.S. were conducting only 40% of futures trading worldwide in 1997, down from 78% in 1988. Fred Vogelstein, *Futures Marts in the U.S. Run Scared*, WALL ST. J., June 10, 1996, at C1.

249. *See generally* Bowe, *supra* note 248, at 4 (describing how the Chicago Board of Trade clings to its open outcry trading system and falls from first to third place in exchange trading volume).

long as possible.[250] Market share gradually slipped away to the over-the-counter derivative markets and to the electronic exchanges abroad. Like the American car manufacturers in the 1970s, the exchanges and their members saw their volume being eroded by more nimble competitors, but refused to compete, preferring shelter in their dwindling market share to the risks of competition.

The commodity exchanges in America were unable to push through regulations that would stop the over-the-counter trading. Swaps and other such derivatives had slipped past the lobbyists for the exchanges and were now too big to stop. Furthermore, the CFTC was cut off from regulating over-the-counter derivatives by Congress after the Broker-Dealer Lite fiasco. The exchanges then decided to seek entry to over-the-counter trading.[251] The CFTC adopted rules to deregulate over-the-counter derivatives.[252] This proposal was enacted into law by the Commodity Futures Modernization Act of 2000 ("CFMA").[253] Among other things, the legislation, through what in part is sometimes called the "Enron amendment," exempted most over-the-counter derivatives from regulation as long as the parties were large institutions or wealthy individuals.[254] The commodity exchanges were allowed to keep their contract market monopoly over markets in which small traders were allowed to participate. The CFMA also allowed trading in single stock futures under a strange formula in which the CFTC and SEC

250. *See generally* Markham, *The Commodity Exchange Monopoly, supra* note 128, at 1014–15 (describing franchise concerns of floor members). Demutualization, however, offers a way for the exchange members to recapture their capital investment and seek to become more competitive. *See generally* Caroline Bradley, *Demutualization of Financial Exchanges: Business as Usual?,* 21 NW. J. INT'L L. & BUS. 657 (2001) [hereinafter Bradley, *Demutualization*].

251. *See* John M. Broder, *Wide Open Once Again? Chicago Exchanges Seek to Loosen Yoke of Regulation*, N.Y. TIMES, June 4, 1997, at D1.

252. *See* A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed. Reg. 42,256 (Aug. 10, 2001).

253. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended in scattered sections of 7 U.S.C.).

254. The amendment received this informal reference as a result of the fact that the Enron Corporation, a large trader in over-the-counter energy derivatives, was its principal sponsor before the company went bankrupt.

shared jurisdiction.[255] Commodity markets conducting trading in single stock futures were required to adopt rules equivalent to those in the securities industry, including insider trading prohibitions.[256] Margin requirements also had to match those in the securities industry. The level for stock margins was therefore applied, a level several magnitudes greater than for futures trading.[257] This was one of the few instances where Congress rejected competitive regulation and mandated that the CFTC adopt SEC requirements.

Although the SEC won this regulatory encomium from Congress, it was facing other challenges. The securities markets

255. The Shad-Johnson Accords had prohibited such single stock futures. *See* note 206 and accompanying text. For the CFTC's notice rules for securities exchanges to become designated contract markets in securities products, see Designated Contract Markets in Security Futures Products: Notice-Designation Requirements, Continuing Obligations, Applications for Exemptive Orders, and Exempt Provisions, 66 Fed. Reg. 44,960 (Aug. 27, 2001).

256. The National Futures Association ("NFA") was required to conform its customer protection rules to those of the SEC, thereby introducing insider trading prohibitions into the futures markets. *See* Self Regulatory Organization; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Futures Association Relating to Security Futures Products, Exchange Act Release No. 34-44,823, 66 Fed. Reg. 49,439 (Sept. 27, 2001) (NFA conforming its rules). Customers trading on the futures markets will not receive SIPC insurance, but customers trading such instruments on securities markets will be insured. Applicability of CFTC and SEC Customer Protection, Record Keeping, Reporting and Bankruptcy Rules, Comm. Fut. L. Rep. (CCH) ¶ 28,641 (C.F.T.C. & S.E.C. 2001).

257. The Commodity Futures Modernization Act of 2000 ("CFMA") amended Section 7(c) of the Securities Exchange Act of 1934 to provide the Federal Reserve Board with authority to set margin requirements for futures on individual securities and narrow based indexes. The Federal Reserve Board delegated this rule- making authority jointly to the CFTC and the SEC. Customer Margin Rules Relating to Securities Futures, Exchange Act Release No. 34-44,853, 66 Fed. Reg. 50,720 (Sept. 26, 2001). The CFMA required margin for single stock futures to be no lower than the lowest level of margin required for comparable options contract traded on national securities exchanges. Rules proposed by the CFTC and SEC established a minimal initial and maintenance margin level of 20% of the current market value of the position. This 20% level is far in excess of the normal margin requirements for futures contracts in the commodity futures industry, where margins are often less than 5% of the value of the contract. Customer Margin Rules Relating to Securities Futures; Applicability of CFTC and SEC Customer Protection, Recordkeeping, Reporting, and Bankruptcy Rules, Exchange Act Release No. 34-44,996, 76 S.E.C. Docket 383 (Oct. 29, 2001); Customer Margin Rules Relating to Securities Futures, Exchange Act Release No. 34-44,853, 66 Fed. Reg. 50,720 (Sept. 26, 2001).

were trending up during most of the 1990s, volume was increasing, and more investors were being drawn into the markets. Despite all of these positive aspects, the securities markets, like the futures markets, faced many challenges due to new computer technology. The computer allowed the creation of "SOES Bandits,"[258] and these traders soon became "day traders." The computer thus allowed even small traders to trade like professionals, creating a new set of regulatory problems for the SEC.[259] In addition, the Internet permitted small investors to

258. SOES Bandits is a reference to traders who used the automated Nasdaq Small Order Execution System ("SOES") to pick off market maker quotes before they could be changed where an event with market effect occurs. The Nasdaq market makers were subject to stiff withdrawal restrictions after they exited the market en masse during the stock market crash of 1987. *See* Timpinaro v. SEC, 2 F.3d 453 (D.C. Cir. 1993) (describing SOES Bandits). To avoid the SOES Bandits, the Nasdaq market makers engaged in several collusive practices that became the subject of an SEC investigation and caused the reorganization of the NASD. *See* In re Certain Market Making Activities on NASDAQ, Exchange Act Release No. 34-40,900, 68 S.E.C. 2693 (Jan. 11, 1998) (order describing these collusive practices).

259. *See generally* Caroline Bradley, *Disorderly Conduct: Day Traders and the Ideology of "Fair and Orderly Markets,"* 26 J. CORP. L. 63 (2000) (describing problems caused by, and regulation of, day traders). The day trader entered orders through computerized systems operated by discount brokers at low commission rates. The system allowed day traders to "scalp" by quick in-and-out trades that sought short term profits. However, most day traders in fact lost money. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 333–34 (survey finds that 90% of day traders lost money). These traders raised the concern that their trading was adding volatility to the market. *See* Edward Watt & David Barboza, *Internet Stocks Falter, Causing Wider Worries*, N.Y. TIMES, Jan. 23, 1999, at A1. Day traders were often avoiding or evading margin requirements by having their broker-dealer arrange loans among customers and by closing out positions before the end of the trading day. *See generally* Ruth Simon, *Day-Trading Firms' Moves that Skirt Margin-Lending Rules are Being Probed*, WALL ST. J., June 23, 1999, at C1. The NYSE and NASD imposed special margin restrictions on day traders to curb these practices. Order Approving Proposed Rule Changes Relating to Margin Requirements for Day Trading, Exchange Act Release No. 34-44,009, 74 S.E.C. Docket 1000 (Feb. 27, 2001). For more on day trading margin requirements, see *id.* Short sale tick test restrictions were also being avoided by these traders. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 333. The SEC, the CFTC, and the FTC (still another layer of regulation) conducted a coordinated sweep operation that resulted in fourteen firms being charged with fraud in promoting their day trading programs. Ronald Taylor, *14 Firms Snagged in Coordinated Move as Day Trading Promoters Cited for Fraud*, Sec. Reg. & L. Rep. (BNA) 586 (May 8, 2000). There were also some tragedies. Mark (the "Rocket"), a failed day trader, attacked his brokerage

trade online.[260] This medium was also used to evade the gatekeeper status of analysts, so that "pump and dump" schemes became common.[261]

More threatening to the status quo in the securities industry were the electronic communication networks ("ECNs"), which were no more than order matching services that had no market makers.[262] ECNs were popular with institutions because they removed intermediaries, such as the exchange specialist, from the transaction, thereby saving costs.[263] The SEC ruled initially that ECNs were not exchanges because they did not make a continuous market in securities,[264] thus freeing the ECNs from the onerous regulation imposed by the SEC on the exchanges. The popularity of ECNs distressed Nasdaq and the stock exchanges, since they were losing large amounts of volume to

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firm and killed twelve people. Another failed day trader threw his wife off a balcony in order to obtain the proceeds from her life insurance policy. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 334.

260. Online trading was a boon for the discount brokers and posed a threat to the large full service brokers. Charles Schwab, the largest online broker, saw its stock capitalization value exceed that of Merrill Lynch (but dropping to less than half of that of Merrill Lynch after the market downturn that began in 2000). Merrill Lynch resisted the introduction of online trading, but was finally forced by competition to offer this product. *See* 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 295–97, 353.

261. HAZEN TREATISE, *supra* note 51, § 14.18, at 292 (describing pump and dump schemes). These operations involved such colorful characters as Tokyo Joe's S.A. and various students, causing the SEC to set up an Office of Internet Enforcement and a "cyberforce" to which 200 lawyers were assigned. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 293, 344–45.

262. Instinet was the pioneer in this field. *See* Rebecca Buckman, *Plan by Chicago Exchanges to Offer Extended Trading is Sign of the Times*, WALL ST. J., Aug. 23, 1999, at C11. Island ECN has also been a popular electronic trading platform. It was seeking to become an exchange. Greg Ip, *Trading Places: The Stock Exchanges, Long Static, Suddenly are Roiled by Change*, WALL ST. J., July 27, 1999, at A1.

263. *See generally* Greg Ip et al., *Market Structure Debate Embroils Street*, WALL ST. J., Feb. 22, 2000, at C19 (describing growth of ECNs).

264. *See, e.g.*, Self-Regulatory Organizations; Delta Government Options Corp.; Order Granting Temporary Registration as a Clearing Agency, Exchange Act Release No. 34-27611, 55 Fed. Reg. 1890 (Jan. 19, 1990) (describing "exchange" as one that maintains a continuous market); Self-Regulatory Organizations; Delta Government Options Corp.; Order Granting Temporary Registration as a Clearing Agency, Exchange Act Release No. 34-27,611, 55 Fed. Reg. 1890 (Jan. 12, 1990) (same). Nasdaq could itself be defined as an ECN except that it makes a continuous market in securities.

those operations.[265] The large brokerage firms heightened the exchanges' fear with a proposal for a centralized electronic trading system with a central limit order book ("CLOB").[266] Defenders of the exchanges claimed that the ECNs were becoming a cover for the large broker-dealers to internalize their order flow upstairs and away from the exchanges. Critics claimed that CLOB would fragment the market, making it less transparent and, therefore, less efficient.[267] The SEC was sympathetic to the exchanges and raised its long-dead central market concept to suggest an alternative centralization of electronic trading that would prevent fragmentation and preclude the internalization of order flows by broker-dealers.[268] It might seem odd to think of the government defending cartels like the stock exchanges from competition.[269] In the end, the SEC retreated from its proposal, but eventually adopted a regulation designed to make the ECNs more transparent.[270]

Like the commodity exchanges, the stock markets were an endangered species.[271] Despite the regulatory competition be-

265. Nasdaq is retaining only 28% of the volume in the stocks it trades. ECNs were accounting for 42.5% of the volume in Nasdaq stocks in the second quarter of 2002. Jeremy Adams, *Nasdaq Losing Ground to ECNs*, EFINANCIALNEWS, Aug. 5, 2002, *available at* LEXIS, Financial News Group. For a description of the proliferation of ECNs, see 23A MARKHAM & HAZEN, *supra* note 35, § 13.02.

266. Michael Schroeder & Randall Smith, *Sweeping Change in Market Structure Sought*, WALL ST. J., Feb. 29, 2000, at C1.

267. Holman W. Jenkins, Jr., *Wall Street Fuddy Duddies CLOBber the Future*, WALL ST. J., Mar. 8, 2000, at A23. *See also* Matthew Andersen, *Don't CLOBber ECN's*, WALL ST. J., Mar. 27, 2000, at A48 (discussing effect of a CLOB requirement on ECNs).

268. Gretchen Morgenson, *SEC Chief Wants One Site for Posting All Stock Prices*, N.Y. TIMES, Sept. 24, 1999, at A1.

269. *See* Randall Smith, *Will NYSE Get Bowled Over by Rivals?,* WALL ST. J., Jan. 19, 2000, at C1.

270. Regulation ATS (Alternate Trading Systems), 17 C.F.R. § 242.300 (2002).

271. Although the ECNs have not aggressively targeted the NYSE, that exchange had lost a large amount of market share to Nasdaq. The Chicago Stock Exchange was attacking both the NYSE and Nasdaq by trading through the Internet. It became the second largest stock exchange in the U.S., ousting Amex, which is owned by Nasdaq, from that position. Joel Seligman, *Rethinking Securities Markets: The SEC Advisory Committee on Market Information and the Future of the National Market System*, 57 BUS. LAW. 637, 672 n.148 (2002). The ECNs have focused on Nasdaq stocks. John Labate, *High — Tech Systems Jolt Old Markets into Action*, FIN. TIMES (London), June 6, 2002, at 4.

tween the CFTC and SEC, both markets had been undercut by their clinging to the franchises given to them under, respectively, the Commodity Exchange Act of 1936 and the Securities Exchange Act of 1934. Both commodity and stock exchanges were undermined by trading in non-conventional (and less regulated) markets. The over-the-counter derivatives threatened the commodity exchanges, and the ECNs were wreaking similar havoc in the stock markets.

VI. FINANCIAL SERVICES AUTHORITY OF THE U.K.

The regulatory structure for financial services in the U.K. has its own history. The Bank of England, which was founded in 1694 as a private institution, provided much of that regulation until the latter part of the twentieth century.[272] Its regulatory role was, however, executed principally through "raised eye-

Nasdaq responded to this threat by creating its own electronic trading platform — SuperMontage. Kate Kelly, *SEC Clears New Nasdaq Trading Platform*, WALL ST. J., Aug. 29, 2002, at C1. Nasdaq also sought to mimic the European exchanges by demutualizing and selling its own stock to raise capital. Susan Harrigan, *Nasdaq Trading in Old System*, NEWSDAY, July 10, 2002, at A41. *See also* Bradley, *supra* note 250 (discussing demutualization plans of stock and commodity exchanges around the world and implications of that phenomenon). Nasdaq was also seeking linkages with foreign exchanges. Terzah Ewing, *NASD Presents Details of its Plan for Nasdaq Europe*, WALL ST. J., Nov. 5, 1999, at C12. It did not have much success with that effort. David Ibson & Mariko Sanchanta, *Nasdaq Japan Faces Up to Uncertain Future*, FIN. TIMES (London), Aug. 15, 2002, at 29 (describing how the Nasdaq plan to globally link America, Japan, and Germany ran into difficulty in Japan, and Nasdaq decided to withdraw from that market). *See also generally* Phred Dvorak & Craig Karmin, *Saga of Series of Poor Moves*, WALL ST. J., Aug. 19, 2002, at C1 (describing reasons for failure); Isabelle Clary, *Nasdaq Turns to Germany in Bid to Expand Globally*, SEC. INDUSTRY NEWS, June 24, 2002, *available at* 2002 WL 8195226 (Nasdaq seeks new alliances in Europe to expand its trading).

The commodity exchanges were having similar problems. A linkage between Eurex and the Chicago Board of Trade ("CBOT") fell apart in 2002, but the CBOT announced it would be trading electronically side-by-side with its trading floor. David Greising, *On Bickering Street, Sounds of Conciliation*, CHICAGO TRIBUNE, Aug. 2, 2002, at B1. The CBOT was also seeking to demutualize. Jeremy Grant, *CBOT Near Demutualization*, FIN. TIMES (London), Aug. 12, 2002, at 15.

272. The Bank of England was nationalized in 1946, but given operational independence in 1997. Bank of England, *About the Bank: Did You Know . . . Historical Trivia*, *at* http://www.bankofengland.co.uk/didyouknow.htm (last visited Jan. 29, 2003).

brows," a form of regulation lent force by the knowledge that disapproval by the Bank of England could exclude a firm from the financial markets.[273] The Bank was also the U.K.'s central bank and lender of last resort.[274] A more formal bank regulatory system was introduced in the Banking Act 1979,[275] which was in turn replaced by a strengthened Banking Act 1987.[276]

Lloyd's of London, a financial club that self-regulated the City's insurance industry, was shaken by scandals in the 1970s. An investigation was conducted by Sir Henry Fisher at the behest of the government and a new reform law was enacted in 1982.[277] This legislation, however, carried forward Lloyd's self-regulation, and did not prevent further scandals or the losses that came from a series of disasters in the 1980s.[278] The securities and commodity markets in the U.K. also operated in a club-like fashion for much of their history.[279] Though the London Stock Exchange was the primary regulator of morals, the Bank of England and government agencies played a loose role during times of crisis. A Prevention of Fraud Act was adopted in 1958,

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273. *See* Jane Martinson, *Nine Finance Watchdogs Must Squeeze Into One Skin*, FIN. TIMES (London), Oct. 9, 1997, at 9 (referencing "raised eyebrow" approach to regulation by the Bank of England).

274. George Peabody & Co. was saved by a loan of £800,000 during the Panic of 1857. His firm would evolve into J.P. Morgan & Co., now JP Morgan Chase. 1 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492–1900), at 357 (2002) [hereinafter 1 MARKHAM, A FINANCIAL HISTORY OF THE U.S.]. The Bank of England would also rescue the Barings banking firm in 1890 during the Baring Panic of that year. *Id.* at 308. The Bank of England declined a further rescue of the Barings bank in 1995, after the firm lost over $1 billion from the unauthorized futures trading of a twenty-eight year old employee, Nicholas Leeson. JUDITH H. RAWNSLEY, TOTAL RISK: NICK LEESON AND THE FALL OF BARINGS BANK (1995).

275. *See* Heidi Mandanis Schooner & Michael Taylor, *Convergence and Competition: The Case of Bank Regulation in Britain and the United States*, 20 MICH. J. INT'L L. 595, 629–35 (1999) (describing bank regulation in the U.K. and the background of the Banking Act 1979 and its revision by the Banking Act 1987).

276. Philip N. Hablutzel, *A Legal Sampler: British Banks' Role in U.K. Capital Markets Since the Big Bang*, 68 CHI.-KENT L. REV. 365, 373 (1992).

277. Lloyd's Act, 1982, c. 14 (Eng.).

278. Ian Kelley, Note, *Regulatory Crisis at Lloyd's of London: Reform from Within*, 18 FORDHAM INT'L L.J. 1924, 1924–25 (1995).

279. For an extensive description of the London financial markets, see 1–4 DAVID KYNASTON, THE CITY OF LONDON (1994).

but it did little to impose affirmative regulation.[280] This regulatory approach was questioned after a series of scandals that began in the 1970s in the securities markets.[281] A collapse of the tin market in 1985 raised additional concerns with regulation. The fiasco cost members of the London Metals Exchange £600 million, as well as threatened the exchange's existence.[282]

In the midst of these events, Professor Jim Gower prepared a white paper for the Department of Trade and Industry[283] on steps needed for investor protection.[284] This led to corrective legislation in the form of the Financial Services Act, which implemented what became known as the "Big Bang" in 1986. The legislation drew heavily from the SEC regulatory model in the U.S., and, among other things, eliminated fixed commissions.[285] Furthermore, the separation of "stock jobbers," (i.e., dealers and brokers), was removed in favor of competing market makers.[286]

The Big Bang legislation also created a Securities and Investment Board ("SIB") that reported to the Department of Trade and Industry. This was a variation on the SEC model — the members of SIB included government officials as well as private individuals, and the SIB had no enforcement powers.[287] Financial firms were required to register with an SRO or with the SIB. The SROs were in turn required to regulate the con-

280. Richard Northedge, *Scandals Led to New Legislation for London Financial District*, SUNDAY BUS. (London), Nov. 20, 2001.

281. Henry Laurence, *The Rule of Law in the Era of Globalization*, 6 IND. J. GLOBAL LEGAL STUD. 647, 660–61 (1999).

282. Kenneth Gooding, *Metals Business Booms*, FIN. TIMES (London), May 5, 1994, at 14.

283. This ministry was the successor to the Board of Trade that regulated the colonies and corporations that owned America before their charters were revoked by the Crown. 1 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 274, at 29–35 (2001).

284. LAURENCE CECIL BARTLETT GOWER, REVIEW OF INVESTOR PROTECTION (1985).

285. Fixed commissions had been eliminated in the U.S. on "May Day" in 1975 as the result of an SEC mandate. H.R. REP. NO. 94-123, at 46 (1975).

286. *See* Patrick M. Creaven, Note, *Inside Outside Leave Me Alone: Domestic and EC-Motivated Reform in the UK Securities Industry*, 60 FORDHAM L. REV. S285, S287–89 (1992) (describing Big Bang legislation). *See generally* Norman S. Poser, *Big Bang and the Financial Services Act Seen Through American Eyes*, 14 BROOK. J. INT'L L. 317, 318 (1988) (describing Big Bang); NORMAN S. POSER, INTERNATIONAL SECURITIES REGULATION: LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES MARKETS 27–31 (1991).

287. Laurence, *supra* note 281, at 662.

duct of their members and could impose fines, censures, and bans.[288] One of the more important of the SROs was the Securities and Futures Authority,[289] which combined the regulation of futures and securities, an approach not followed in the U.S. Although this concept appears to be a mixture of the Municipal Securities Rule Making Board ("MSRB") and the SEC in the U.S.,[290] the SIB was actually a compromise designed to preserve the culture of the City of London's club-like regulation.

The SIB proved to be a reluctant and ineffective regulator, and another series of scandals led to calls for further reform.[291] The scandals included the "Blue Arrow" rights affair, Robert Maxwell's defalcations, the BCCI debacle, and several insider trading cases.[292] The crisis at Barings plc.,[293] then precipitated

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288. Member firms were required to second employees in order to provide a staff for the SROs. *Id.* at 662.

289. Helen Nugent, *Taking Grief Out of Grievances*, INDEP. (London) Sept. 20, 1998, at 20.

290. The MSRB is a self-regulatory body composed of members representing securities firms, bank representatives, and the public. It is a hybrid body that was given the responsibility of enacting rules for the registration and regulation of bank and non-bank municipal securities dealers. Its authority is limited to proposing and adopting rules to regulate transactions in municipal securities. Those rules must be approved by the SEC before they are effective. Enforcement of MSRB rules is left to the SEC, the NASD, and the bank regulatory agencies. HAZEN TREATISE, *supra* note 51, § 10.5, at 539–45.

291. Richard Northedge, *Scandals Led to New Legislation for London Financial District*, SUNDAY BUS. (London), Nov. 20, 2001, *available at* LEXIS, News Group File.

292. *See generally* TOM BOWER, MAXWELL THE OUTSIDER (1992); PETER TRUELL & LARRY GURWIN, FALSE PROFITS: THE INSIDE STORY OF BCCI, THE WORLD'S MOST CORRUPT FINANCIAL EMPIRE (1992); Betty M. Ho, *Rethinking the System of Sanctions in the Corporate and Securities Law of Hong Kong*, 42 MCGILL L.J. 603, 629 (1997) (describing the "Blue Arrow" affair); Barry A.K. Rider, *The Control of Insider Trading — Smoke And Mirrors*, 19 DICK. J. INT'L L. 1 (2000) (discussing lack of enforcement against insider trading).

Pensioners had also been the subject of sales schemes in which, under a new law designed to encourage the privatizing of pensions, they were "mis-sold" on the drawbacks of investing on their own rather than in a public or company pension scheme. Simon Robinson, *Follow the Money*, TIME (Int'l ed.), July 27, 1998, at 36. *See generally* Richard Nobles & Julia Black, *The Privatization Process: Pensions Mis-Selling — The Lessons for Regulating Privatized Social Security*, 64 BROOK. L. REV. 933 (1998); Steve Stecklow & Sara Calian, *Financial Flop: Social Security Switch in U.K. is Disastrous; A Caution to the U.S.?*, WALL ST. J., Aug. 10, 1998, at A1.

293. *See supra* note 274.

more legislation, which created the FSA-UK in 1997.[294] The FSA-UK is an "independent non-governmental body which exercises statutory powers . . . ."[295] The agency was to assume the duties of nine regulatory entities,[296] abandoning the clubby use of SROs.[297] In 1998 the FSA-UK was even given the authority to oversee the banks, taking that power away from the Bank of England.[298]

The FSA-UK became a monolithic super regulator that was firmly in the hands of the government, and was to be "the single governing entity of the entire financial services spectrum, from securities and futures trading to funeral planning."[299] The agency was given responsibility to regulate virtually every aspect of finance, assuming the same roles played in the U.S. by the SEC, the CFTC, federal bank regulators, and state banking, insurance and securities commissions, as well as the SROs.[300] It was also provided with expanded enforcement powers that included the right to bring actions against violators and impose sanctions.[301] The FSA-UK, however, started with only 2,000 employees for the regulation of 10,000 companies.[302] Even so,

294. Thomas Sims, *Single Regulators Are Catching on in Europe*, WALL ST. J. (International), Mar. 6, 2001, at A14.

295. FSA, INTRODUCTION TO THE FINANCIAL SERVICES AUTHORITY 4 (2001) [hereinafter INTRO. TO THE FSA]. The agency is funded by the industry and is accountable to Treasury Ministers. *Id.*

296. See FSA, *Further Integration of Financial Regulatory Services at the FSA*, (Feb. 2, 2001), *at* http://www.fsa.gov.uk/pubs/press/2001/017.html (listing the integrated regulators); *Nine into One Does Go*, REINSURANCE MAG., June 8, 1998, at 28, *available at* http://www.insurancewindow.net/story.asp?l sectioncode=00&arch=true&storycode=14043 (same).

297. There were to be no industry representatives on the FSA-UK. *Helen Liddell Interview: New Tricks for Old Watchdogs*, INVESTORS CHRONICLE, Oct. 31, 1997, at 21.

298. André Scheerer, *Credit Derivatives: An Overview of Regulatory Initiatives in the U.S. and Europe*, 5 FORDHAM J. CORP. & FIN. L. 149, 198 (2000). The Bank of England retained the right to set interest rates under the Bank of England Act 1998. *See* Bank of England Act, 1998, c. 11, § 7, sched. 2; Bank of England, *About the Bank: Core Purposes*, *at* http://www.bankofengland.co.uk/corepurposes.htm (last visited Feb. 2, 2003).

299. *The Risk Business*, LAWYER, Sept. 10, 2001, at 21.

300. Silvia Ascarelli, *Britain's Fiscal Watchdog to Bite as Well as Bark*, WALL ST. J., Nov. 30, 2001, at A13.

301. *The Seamless Web of Financial Regulation*, COMPLIANCE MONITOR, Oct. 2001, at 1.

302. Ascarelli, *supra* note 300. The agency also admitted that many of these employees were inexperienced in regulation. Suzy Jagger, *Death of Capital-*

immediate concern was raised that the new agency would become bureaucratic and intrusive and seek to implement a rule-based regulatory system like the one in the U.S.[303]

The FSA-UK took several steps to unify regulation. First, a single ombudsman was to be created by the agency to handle complaints by customers in all sectors of public finance,[304] as opposed to the various hotlines for federal and state agencies in the U.S., the numerous arbitration tribunals of the SROs, and the singular reparations procedure at the CFTC in the U.S. The FSA-UK further replaced the six separate insurance funds with a single Financial Services Compensation Scheme ("FSCS"), which provided customers with compensation in the event of the insolvency of a financial service firm.[305] This sharply contrasts with the U.S. system that spreads responsibility among the FDIC, the Bank Insurance Fund, the Savings Association Insurance Fund, the SIPA Corporation ("SIPC"), the Pension Benefit Guaranty Corporation, and the funds created by states for insurance companies.

The FSA-UK is also seeking publication of comparative information disclosures for a range of financial instruments that would allow more informed investment decisions.[306] The FSA-UK assigned one office to develop policy on prudential issues across all financial sectors, so as to develop a common approach

ism, THE MIRROR (London), June 29, 2002, at 14. *See also* Jeffrey L. Hiday, *Hot Properties: U.K. Regulators Vie for Compliance Staffers in Tight Market*, WALL ST. J., Nov. 3, 1997, at A17 (expressing concern with whether the agency would be able to keep even these employees). The 1999 budget for the FSA-UK was £154 million. George Graham, *Banking Watchdog Budgets for Reduced Costs*, FIN. TIMES (London), Feb. 17, 1998, at 11. In the U.S., the SEC's budget alone was twice that amount and has recently been increased to $ 776 million. Alec Klein & Dan Eggen, *U.S. Opens Criminal AOL Probe: Justice Dept. to Focus on Unusual Accounting*, WASH. POST, Aug. 1, 2002, at AO1.

303. Silvia Ascarelli, *Deals & Deal Makers: New U.K. Financial Regulator Draws Fire*, WALL ST. J., May 30, 2001, at C16.

304. Nugent, *supra* note 289. The FSA-UK appoints the board of this Financial Ombudsman Service ("FOS") and promulgates its rules, but the FOS is operationally independent of the FSA-UK. *See* INTRO. TO THE FSA, *supra* note 295, at 18.

305. *Id.* The FSA-UK appoints the board of the FSCS and promulgates its rules, but the FSCS is operationally independent of the FSA-UK. *See id.*

306. Howard Davies, *The Coming of the Single Financial Regulator*, FIN. TIMES (London), July 16, 2001, at 2.

to risk and capital requirements.[307] There has been no comparable effort in the U.S., where there are separate capital requirements for insurance companies, banks, broker-dealers, and futures commission merchants. As a lawyer for the FSA-UK notes: "[o]ur advantage is that we can look at the market as a whole . . . . We can see what's falling between the cracks."[308] The agency also announced that it was streamlining the existing fourteen rulebooks for financial services into one.[309] The FSA-UK has been focusing its regulatory attention on high-risk firms, while requiring other firms to report and to comply with conduct standards set out in its rulebook.[310] By contrast, the FSA-UK specified several governing principles involving management responsibility and internal control systems, as well as financial requirements.[311] The agency, like the SEC, placed heavy emphasis on supervisory responsibilities of managers.[312] Of course, the FSA-UK did not stop financial problems in the U.K., and, in fact, it encountered criticism for its handling of the Equitable Life closure.[313] Thereafter, the agency became more aggressive in the regulation of the insurance sector, but still depended on company managers to prevent wrongdoing.[314] The FSA-UK also began a program of

307. Andrea Felsted, *Financial Consolidation Held Back by Inconsistent Regulation*, FIN. TIMES (London), July, 13, 2000, at 2; *Equitable Life: FSA Response to Baird Report,* Oct. 17, 2001, HERMES Database. This was a change from the previous sector-by-sector analysis used before the creation of the FSA-UK by the various regulatory bodies in London. *Outcome of Consultation on Prudential Regulation Endorses "Single" Regulator,* May 10, 2000, HERMES Database.

308. *The Risk Business*, LAWYER, Sept. 10, 2001, at 21.

309. The agency stated that its single rulebook would still differentiate for different types of businesses and customers. *FSA Plan & Budget for 1999/2000*, Feb. 3, 1999, HERMES Database. As an interim measure, the old rulebooks were incorporated into a single sourcebook. George Walker, *Regulatory Review 2001*, FIN. REG. INT'L (London), Feb. 2002, *available at* LEXIS, England & Wales, Journals.

310. Davies, *supra* note 306.

311. Walker, *supra* note 309.

312. Maeve Bromwich, *The Watchdog Needs a Firm Hand*, LAWYER, Dec. 2, 1997, at 13.

313. James Mackintosh, *Regulator Faces Rising Tide of Trouble*, FIN. TIMES (London), Oct. 20, 2001, at 16.

314. *Change Ongoing as FSA Gets to Grips with Its UK Financial Markets Role*, INS. DAY, June 26, 2002.

The FSA-UK also began a program of enforcement actions, imposing fines and banning wrongdoers from trading in London.[315]

Like markets in the U.S., the London markets were affected by the new competition. The London International Financial Futures and Options Exchange ("LIFFE") had become the second largest commodity exchange in the world, behind the Chicago Board of Trade.[316] Nevertheless, market share was fleeing rapidly to the electronic trading systems on Eurex in Germany. In 1998 LIFFE closed its trading floor, abandoning its open outcry system in favor of electronic trading.[317] But it was too late for LIFFE to regain its position, and the exchange was later acquired by Euronext, the continental exchange that had already combined exchanges in Paris, Brussels, Amsterdam, and Lisbon.[318]

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315. One enforcement action involved the manipulation of stock prices on the Swedish Stock Exchange by the "Flaming Ferraris," a group of traders working at Credit Suisse First Boston in London. James Archer, the son of Lord Archer (who was himself in prison for perjury), was a member of this group, which was named after their favorite cocktail. James Archer was banned for life from working in the City by the FSA-UK. Sanctions were also imposed on other members of the group. James Mackintosh, *James Archer Banned from City Trading for Shares Deception*, FIN. TIMES (London), July 28, 2001, at 3. Another enforcement case resulted in a $500,000 fine imposed on PaineWebber International for failing to have adequate anti-money laundering procedures in place. Ernest Beck, *PaineWebber Receives Fine by U.K. Agency*, WALL ST. J., Aug. 23, 2001, at C18.

316. *Futures Exchanges: Everlasting LIFFE*, ECONOMIST, July 5, 1997, at 73.

317. Alan Cowell, *London Futures Exchange to Reorganize*, N.Y. TIMES, Nov. 3, 1998, at C4; *London Exchange Begins Electronic Trading System*, WALL ST. J., Dec. 1, 1998, at C17. As one source notes:

> CBOT was once the dominant global futures market, but Eurex now occupies that position. . . . [T]he Swiss-German market managed in the first seven months of 2002 to expand on its global leadership position. During this period, it managed a total of 445 million contracts, up 20% on the first seven months of 2001. Its main European rival, the Euronext/Liffe axis, managed 419 million contracts; Chicago Mercantile Exchange 319 million contracts; and CBOT 186 million contracts.

Eurex Aims to Open Up U.S. Market, HANDELSBLATT (Eng. version), Aug. 19, 2002, *available at* LEXIS, Global News Wire.

318. LIFFE was acquired by Euronext in 2001. Alex Skorecki, *Exchanges Take First Steps to Alliance*, FIN. TIMES (London), Sept. 5, 2002, at 28.

The London Stock Exchange ("LSE"), Europe's largest, was also dealing with this new competition.[319] The exchange was involved in a major calamity in trying to upgrade its computerized systems and create a paperless settlement system. The unsuccessful project, called "Taurus," caused losses totaling hundreds of millions of dollars.[320] The LSE then created an electronic, order-driven trading system[321] and decided to demutualize and become a commercial company. As a result, the LSE's listing authority was transferred to the FSA-UK.[322] Thereafter, the LSE announced that it was planning to merge with the Deutsche Börse in Frankfurt. The merged company was to be known as iX-International Exchange and was to be linked with the Nasdaq market in the U.S.[323] The proposal was widely criticized and set off a competing takeover effort by the OM Gruppen AB ("OM"), the owner of the Stockholm Stock Exchange.[324] The LSE survived, but was forced to reorganize itself and drop the proposal to merge with the Deutsche Börse.[325]

VII. FINANCIAL SERVICES AGENCY OF JAPAN

Like the U.S. and the U.K., the form of Japan's present regulatory structure is best explained by its history.[326] After World War II, General Douglas MacArthur's Supreme Command re-

319. *See generally* Bradley, *supra* note 250, at 662–64 (describing the LSE and its history).

320. Glenn Whitney, *Giant London Bourse Seeks New Identity and Focus After Costly Project Fails*, WALL ST. J., April 22, 1993, at A11.

321. Sara Calian & Sylvia Ascarelli, *London Launches Big Bang II for Share Trading*, WALL ST. J., Oct. 20, 1997, at A20.

322. FSA, THE TRANSFER OF THE LISTING AUTHORITY TO THE FSA 3 (Dec. 1999), *available at* http://www.fsa.gov.uk/pubs/cp/cp37.pdf.

323. Erik Portanger, *Swedish Concern OM Launches Hostile Bid Valued at $1.19 Billion*, WALL ST. J., Aug. 30, 2000, at A18.

324. OM also supplied support services for other exchanges and trading platforms, including the California Power Exchange. Silvia Ascarelli, *Swedes Set Formal Bid for the LSE*, WALL ST. J., Sept. 12, 2000, at A21.

325. *See generally* Bradley, *supra* note 250, at 697–98 (describing the takeover battle).

326. Japan has been credited with creating the world's first futures exchange. Mark D. West, *Private Ordering in Japan, Private Ordering at the World's First Futures Exchange*, 98 MICH. L. REV. 2574 (2000). Stock markets were organized in 1874 under an ordinance that was based on the rules of the London Stock Exchange. Andrew M. Pardieck, *The Formation and Transformation of Securities Law in Japan: From the Bubble to the Big Bang*, 19 UCLA PAC. BASIN L.J. 1, 7 (2001).

quired the adoption of provisions from U.S. laws regulating finance, including the securities laws and the Glass-Steagall Act.[327] This new legislation established a Securities Commission for the Supervision of Securities Business based on the American SEC.[328] Japan did not permit bank holding companies, but banks became members of the *keiretsu*, i.e., large companies joining in cooperative units with cross-shareholding, which became the dominant force within the Japanese economy after World War II.[329] The Bank of Japan acted as the country's central bank, setting monetary policy, while the Ministry of Finance ("MoF") was responsible for financial policy.[330]

The MoF became a monolithic component of Japanese finance[331] and managed the economy on both a micro and macro level, leaving only a limited central banking role to the Bank of Japan. To secure its position, the MoF abolished the Securities Commission for the Supervision of Securities Business in 1952 and replaced it with its own Securities Bureau.[332] Other aspects of the U.S.-style regulatory system were also abandoned in later years.[333] The MoF then assumed a dual role of regulator and

327. The provisions for securities and banking regulation were set forth in Article 65 of the Japanese Securities and Exchange Law. Hideki Kanda, *Securitization in Japan*, 8 DUKE J. COMP. & INT'L L. 359, 367 (1998).

328. Laurence, *supra* note 281, at 669.

329. *See* Corinne A. Franzen, *Increasing the Competitiveness of U.S. Corporations: Is Bank Monitoring the Answer*, 2 MINN. J. GLOBAL TRADE 271, 292 (1993) (describing the cross-shareholding of the *keiretsu*). The American occupying authorities tried to break up the *zaibatsu*, or cartels, which had controlled Japan's economy before World War II. Gregory D. Ruback, Comment, *Master of Puppets: How Japan's Ministry of Finance Orchestrates Its Own Reformation*, 22 FORDHAM INT'L L.J. 185, 189–90 (1998). They were simply replaced by the *keiretsu*. For a description of the rebuilding of Japan after World War II, see JOHN W. DOWER, EMBRACING DEFEAT: JAPAN IN THE WAKE OF WORLD WAR II (1999).

330. *See generally* Dafei Chen, *Acute Symptoms of Chronic Problems: Japan's Procrastination in Solving Its Bank Crisis, the Current Situation and a Future Perspective*, 9 MINN. J. GLOBAL TRADE 269, 274 (2000).

331. The MoF assumed control of much of Japanese banking during the 1930s. Ruback, *supra* note 329, at 189. During World War II, a Japanese Securities Exchange was created by the government, replacing nine private exchanges. Pardieck, *supra* note 326, at 7.

332. The MoF also created a Banking Bureau and an Insurance Bureau to regulate these industries. An International Finance Bureau conducted oversight of foreign financial activities of private firms. Chen, *supra* note 330, at 274.

333. Laurence, *supra* note 281, at 669.

business promoter.[334] Though it was the sole governmental financial regulator, SROs, including the exchanges and the Japanese Securities Dealers Association, also provided some minimal regulatory functions.[335]

The Japanese economy prospered, experiencing growth rates of 10% a year between 1950 and 1970.[336] The period of growth continued into the 1980s. The Japanese economy was viewed as an "economic miracle," and its manufacturing processes (e.g., "just-in-time") were widely copied. Moreover, the Japanese worker was well disciplined. The average Japanese household had savings of $100,000,[337] much of which was held in postal savings accounts.[338] The high-quality goods produced in Japan penetrated markets everywhere. The U.S. was an especially attractive market, providing easy access, even though Japan's restrictive trade practices were excluding American goods from the Japanese market.

In the 1980s, however, a "bubble economy" developed in Japan. The stock market boomed, and real estate prices more than doubled between 1986 and 1990. Scandals soon unfolded. In the "Recruit Cosmos" affair, Prime Minister Noboru Takeshita resigned after it was discovered that some 160 influential politicians had been given Recruit Cosmos stock at bargain

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334. Pardieck, *supra* note 326, at 8. The MoF often placed its senior officials as executives at financial institutions. These institutions also maintained offices at the MoF to further communications. Ruback, *supra* note 329, at 199–200.

335. Pardieck, *supra* note 326, at 24–27.

336. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 278. The recovery of the Japanese economy was aided by grants and loans from the U.S., as well as a defense umbrella. *Id.*

337. Chen, *supra* note 330, at 277.

338. A unique part of the Japanese financial system has been the provision of postal savings accounts by the government. These accounts received high interest rates and were tax sheltered. In 2000, some 20% of all Japanese personal assets were held in postal savings accounts. BROOME & MARKHAM, *supra* note 11, at 958. In 2002, $25 trillion was held in Japanese postal savings accounts. James K. Glassman, *A Growth Season for Japanese Stocks?*, WASH. POST, Apr. 28, 2002, at HO1. The Japanese government used the monies in these accounts to fund its own operations. The postal savings accounts were placed under the supervision of the Ministry of Posts and Telecommunications, rather than the MoF. Richard E. Nohe, *A Different Time, A Different Place: Breaking Up Telephone Companies in the United States and Japan*, 48 FED. COMM. L. J. 307, 314 (1996).

prices in 1986, just before the company went public.[339] In another scandal, the Hanshin Sogo Bank sold a large amount of stock it held in the Tateho Chemical Company the day before the company announced large losses. No wrongdoing was found, to the consternation of many.[340] Nui Onoue, the "Bubble Lady," became famous for borrowing billions of dollars on her restaurants in order to invest in the stock market. The amounts she borrowed were greater than the value of those properties. She had also used forged certificates of deposit for her trading activities. Eventually, the Bubble Lady, who used séances to pick stocks, was sentenced to twelve years in prison.[341]

The bursting of the Japanese economic bubble at the beginning of the 1990s sent the economy into a deep recession that the country is still struggling with today[342] — massive deflation was experienced; the Nikkei 225 index dropped from 39,000 to 11,000; land prices in large cities dropped eleven years in a row; government debt grew to 150% of GDP, as compared with 33% in the U.S.;[343] and bad debt held by Japanese banks grew to some 30% of GDP.[344] The Hokkaido Takushoku Bank failed, the first to do so in Japan since World War II.[345] Nineteen of Japan's largest banks had capital shortages that threatened their ability to meet the Basel Committees guidelines for international banks.[346] Yamaichi Securities, the fourth largest securities firm in Japan,[347] also failed. Yamaichi had hid its losses in

339. *Ex-NTT Chief Found Guilty in Recruit Scandal*, L.A. TIMES, Oct. 9, 1990, at 3.

340. Laurence, *supra* note 281, at 670.

341. Stefan Wagstyl, *Bank Chief in Japan's Turbulent Years*, FIN. TIMES (London), Jan. 6, 2000, at 12; Robert Thomson, *Institutions in Dock Beside Bubble Lady*, FIN. TIMES (London), Oct. 6, 1992, at 6.

342. The Bank of Japan introduced a zero interest rate policy as a way of putting the economy back on its feet. Ken Belson, *World Business Briefing Asia: Japan: Monetary Policy Unchanged*, N.Y. TIMES, June 13, 2002, at W1.

343. Glassman, *supra* note 338.

344. *Time to Wake Up*, ECONOMIST, Sept. 26, 1998, at 21.

345. Eric C. Sibbitt, *A Brave New World for M&A of Financial Institutions in Japan: Big Bang Financial Deregulation and the New Environment for Corporate Combinations of Financial Institutions*, 19 U. PA. J. INT'L ECON. L. 965, 967 (1998).

346. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 269.

347. The Bank of Japan bailed out the Yamaichi firm in 1965 by agreeing to provide an unlimited amount of loans. 2 MARKHAM, A FINANCIAL HISTORY OF

off-book accounts, apparently with the knowledge of at least one MoF official.[348] In the early 1990s there were a series of "loss compensation" scandals, in which it was discovered that the country's four largest brokerage firms were covering the trading losses of important clients and politicians.[349] In 1997, the nation's largest securities firm, Nomura, became mired in scandal, after it was discovered that the firm had covered the trading losses of a gangster and engaged in widespread abusive sales practices.[350]

The Japanese government took several steps to deal with this deteriorating situation. The Japanese Diet passed the Financial Reform Act of 1992, which allowed the MoF to establish capital requirements for banks and allowed banks to own securities affiliates. The act also aimed to further competition among financial institutions. Furthermore, a Securities Exchange and Surveillance Commission ("SESC") was created in 1992 to police the securities markets.[351] This legislation ostensibly reduced the MoF's role as the director agency for the placement of financial resources.[352] In application, however, the MoF remained firmly in control of financial services firms and the SESC.[353] Greater reform was attempted in 1996 by means of a "Japanese Big Bang" that sought to emulate the one in the U.K. and deregulate Japan's financial services. The Japanese Big Bang tried to ease market entry and remove non-

THE U.S., *supra* note 15, at 343. When the firm failed in 1997, it owed the Bank of Japan $3.95 billion. Three executives were arrested by Japanese authorities. Merrill Lynch bought the Yamaichi securities operations, but lost several hundred millions in dollars over the next few years from that investment. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 268. Merrill Lynch ended up closing most of those operations. David Ibison, *Japan Refuses to Offer Up Easy Money For Foreign Banks*, FIN. TIMES (London), July 2, 2002, at 31.

348. Michiyo Nakamoto, *Prosecutors Raid Industrial Bank of Japan*, FIN. TIMES (London), Feb. 10, 1998, at 6.

349. *See generally* Masahisa Ikeda, *The Legality of Compensating Investors in Japanese Securities Market*, 33 HARV. INT'L L.J. 592 (1992) (describing these scandals).

350. David Ibison, *A Banking Star is Brought to Earth,* FIN. TIMES (London), Aug. 8, 2002, at 15.

351. Pardieck, *supra* note 326, at 9.

352. Sibbitt, *supra* note 345, at 987–89.

353. Chen, *supra* note 330, at 276.

competitive practices.[354] Commissions were unfixed. The plan was formulated by a Financial System Research Council to allow banks, insurance companies, and brokerage firms to compete with each other without the prior restrictions that had kept these sectors separate.[355] The government also announced a "Total Plan" to deal with the mass of non-performing debt in the economy and to dissolve bankrupt companies.[356] Although public funds were used to shore up shaky banks, Japan's banks still maintain some $1.3 trillion in bad debts.[357]

Another scandal arose after the Tokyo Prosecutor's Office staged a large-scale raid involving 100 investigators on the MoF offices in 1998.[358] The Prosecutor was seeking information on bribes in the form of lavish entertainment and discount loans allegedly paid to MoF bank examiners by those being examined.[359] Two examiners were arrested and a third committed suicide.[360] More legislation followed in the form of a Financial Reconstruction Law for failed financial institutions and a Financial Early Strengthening Law that allowed public funds to be used to shore up weak or failing banks. These laws were to

354. Ruback, *supra* note 329, at 217.

355. Jessica C. Wiley, Note, *Will the "Bang" Mean "Big" Changes to Japanese Financial Laws*, 22 HASTINGS INT'L & COMP. L. REV. 379, 380, 394 (1999). Under existing regulations, strict separation of securities and banking was required — even separate entrances were required for a firm with banking and securities operations in the same building. Despite the Big Bang goal of removing such restrictions, they were apparently still in place in July 2002. *Mizuho to Open One-Stop Money Shop*, ASAHI SHIMBUN, July 17, 2002. *See also Yanagisawa Panel Call for Promotion of Market Functioning,* JAPAN WKLY. MONITOR, July 8, 2002, *available at* LEXIS, IACNWS 88685779 (advocating fewer regulatory distinctions among securities, banking, and insurance).

356. Chen, *supra* note 330, at 278.

357. *Hampered*, ECONOMIST, July 13, 2002 (Finance & Economics) [hereinafter *Hampered*].

358. Andrew Chin, *Spoiling the Surprise: Constraints Facing Random Regulatory Inspections in Japan and the United States*, 20 NW. J. INT'L L. & BUS. 99, 99–101 (1999)

359. *Japan's Mighty Ministry Trembles*, FIN. TIMES (London), Jan. 27, 1998, at 4.

360. Ruback, *supra* note 329, at 211. Eventually, 112 MoF officials were sanctioned, along with six of Japan's largest banks. Chin, *supra* note 358, at 100.

be administered by a five-member governmental body called the Financial Reconstruction Commission.[361]

The SESC was transferred out of the MoF in 1998, along with an independent Financial Supervisory Agency, which was succeeded by the Financial Services Agency ("FSA-Japan") in 2000.[362] The FSA-Japan was also given the power, previously held by the MoF, to set securities policy and to regulate securities and banking. The SESC continued its operations under authority from the FSA-Japan, which in turn was supervised by the Financial Reconstruction Commission.[363] More reform legislation was adopted: the ban on holding companies was removed,[364] and consumer protection was enhanced through the Law Concerning the Sale of Financial Products.[365]

Some have expressed concern that all of these reforms may not have accomplished very much. The SESC lacked strong enforcement mechanisms[366] — it is only an investigative agency.

361. *Japan's Financial Sector Reform: Progress and Challenges*, Hakuo Yanagisawa, Minister for Financial Services Japan, Address before the Financial Services Authority (Sept. 3, 2001), *available at* http://www.fsa.go.jp/gaiyou/gaiyoue/presen/20010903.html.

362. Securities & Exchange Surveillance Commission, *History and Functions*, *at* http://www.fsa.go.jp/sesc/english/news/others/20010723.htm (last visited Nov. 18, 2002). The Financial Supervisory agency was merged with the MoF Financial System Planning Bureau to form FSA-Japan. Masaharu Hino, On the Establishment of the Financial Services Agency, Address Before the Bank of England (Sept. 2000), *available at* http://www.fsa.go.jp/gaiyou/gaiyoue/presen/p2000913.html [hereinafter Hino Address]

363. The Financial Reconstruction Commission quickly encountered scandal, and critics charged that it was maintaining the insular and clubby approach of the MoF. *A Loss of Appetite*, ECONOMIST, Sept. 16, 2000 (Japanese Financial Regulation) [hereinafter *A Loss of Appetite*]. The FSA's organization and role in the government is a somewhat confusing one. *See* FSA, *About the Financial Services Agency, Organization* (Jan. 2002), *at* http://www.fsa.go.jp/info/infoe.html.

364. Sibbitt, *supra* note 345, at 993–94.

365. Adopted in 2000, this statute required greater disclosures to customers purchasing financial products. Pardieck, *supra* note 326, at 69–70. A Consumer Contract Act that was also passed in 2000 allowed customers to rescind contracts if they were misinformed about the nature of the transaction and precluded broad disclaimers of liability. *Id.* at 74–78.

366. The SESC chairman promised to "Kick out Rogue Broker-Dealers" and "show up our presence" through enforcement actions. Takeo Takahashi, New Chairman, Inaugural Address (July 23, 2001), *at* http://www.fsa.go.jp/sesc/english/news/others/20010723.htm. The SESC was investigating the manipulation of stock prices by derivative firms trying to avoid paying a bonus cou-

The SESC has no authority to impose sanctions, but may refer matters for sanctions. In practice, however, few referrals have been made to date.[367] In 2001, the SESC had a relatively small staff, at least in comparison to the SEC in the U.S.,[368] and most of them had been transferred from the MoF.[369] To be sure, the MoF does appear to retain some policy control.[370] FSA-Japan also experienced a faltering start. When FSA-Japan did try to take aggressive action by urging vast bad debt write-offs, many small and medium-sized companies went bankrupt.[371] FSA-Japan then eased off, pressuring the banks and using public funds to save the Daiei supermarket chain and Koizumi, a construction company, both of which had massive amounts of bad debt. However, there were no bailouts for small companies.[372] The government nationalized the Long-Term Credit Bank of Japan and the Nippon Credit Bank, after these institutions could no longer be kept afloat.[373] Public funds were also injected into all but one major bank.[374]

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pon on Reverse Convertible Bonds. Press Release, SESC, An Annual Announcement of Activity (Sept. 3, 2001), *available at* http://www.fsa.go.jp/sesc/english/news/others/20010903.htm. In 2000, the SESC filed only five cases with the prosecutor's office and made thirty-four recommendations for disciplinary actions to FSA-Japan. *Id.* Between 1992 to June 2001, the SESC made 188 recommendations to FSA-Japan for disciplinary actions. SESC, *What We Do* ¶ 5, *at* http://www.fsa.go.jp/sesc/english/actions/actions_menu.htm (last visited Jan. 30, 2003).

367. Pardieck, *supra* note 326, at 9–14.

368. The SESC staff is about one tenth the size of the SEC. Phred Dvorak, *Walking Wounded, One Reason Stocks in Japan Stay Low: Zombie Companies*, WALL ST. J., Aug. 28, 2002, at A1; Pardieck, *supra* note 326, at 86; Ruback, *supra* note 329, at 226. The SESC has disputed this contention, noting that it has a much smaller universe to regulate than the SEC in the U.S.. Laurence, *supra* note 281, at 677–78. The SESC is composed of a three member commission and has eleven regional offices. SESC, ORGANIZATION, *available at* http://www.fsa.go.jp/sesc/english/aboutsesc/aboutsesc02.pdf (last visited Mar. 20, 2003).

369. Chen, *supra* note 330, at 269, 285.

370. Ruback, *supra* note 329, at 223–24.

371. *Review*, ASAHI SHIMBUN, July 17, 2002.

372. *Hampered*, *supra* note 357; *Review*, ASAHI SHIMBUN, July 17, 2002.

373. The remaining assets of these banks were sold. Former management of both banks were being prosecuted. Several financial institutions were also put into bankruptcy, a rarity in Japan. Hino Address, *supra* note 362.

374. Hakuo Yanagisawa, *Japan's Financial Sector Reform: Progress and Challenges*, Address Before the Financial Services Authority, London (Sept. 3, 2001), *at* http://www.fsa.go.jp/gaiyou/gaiyoue/presen/p20010903.html.

FSA-Japan announced that it was undertaking inspections of large troubled banks in order to address their bad debt problems.[375] The project was supposed to be a "Japanese sword" for dealing with the problem, but the result was largely to shore up some troubled banks.[376] Critics claimed that FSA-Japan was "whitewashing" the bad debt problem in Japan.[377] After downgrading Japan's debt, a credit rating agency claimed that FSA-Japan was engaging in regulatory forbearance as a way to aid the economy "in the hope that something will turn up."[378] The agency was waffling on reform in other areas. Japan dropped its insurance guaranty for customer funds held in time deposit accounts, limiting claims to about $83,000. This was intended to assure more market discipline, but it instead raised concerns that funds would be pulled out of already unstable institutions, weakening them further.[379] When a similar proposal limiting deposit insurance on ordinary deposit accounts met political opposition FSA-Japan started backtracking.[380] It then extended government insurance on some deposits, a breach of its promise to eliminate unlimited guarantees.[381]

FSA-Japan seemed to be retreating from promised reform measures in the insurance industry and was stalling on allowing commercial banks, such as the one sought by Sony, to be licensed.[382] The Japanese government continued the old MoF role of trying to manage the economy in other ways. Most re-

375. FSA-Japan seems to place heavy regulatory emphasis on inspections, a costly and time-consuming form of regulation requiring considerable manpower. FSA, *Financial Services Agency Program Year 2001 Basic Guidelines and Basic Plan for Inspections* (July 30, 2001), *at* www.fsa.go.jp/news/newse/e20010730-1.html.

376. *Tomomi Miyazaki*, ASAHI SHIMBUN, May 1, 2002.

377. *Japan — Can Japan's Banks Clean Up?,* THE BANKER, May 1, 2002.

378. David Ibison, *Bank Regulator Criticized for Lack of Action*, FIN. TIMES (London), June 6, 2002, at 10.

379. David Pilling, *Regulator Drafts Plan for Japanese Bank Mergers*, FIN. TIMES (London), July 11, 2002, at 9; David Pilling, *Japan May Move to Hasten Banking Shake-Up*, FIN. TIMES (London), July 8, 2002, at 7 [hereinafter Pilling, *Japan May Move*].

380. *Another Tokyo Setback*, WALL ST. J., Aug. 28, 2002, at A14.

381. *Japan Set to Break Deposits Pledge*, FIN. TIMES (London), Sept. 5, 2002, at 1.

382. *A Loss of Appetite*, *supra* note 363. The U.S. also rejected the operation of commercial banks such as one proposed by Wal-Mart and Sony in the U.S. when the GLBA was adopted in 1999. Markham, *Banking Regulation: Its History and Future*, *supra* note 4, at 264, 278 n.347.

cently, despite FSA-Japan's push for a market solution, the government suggested that more banks should merge and that it would offer a higher government guarantee to encourage such actions.[383] In fact, several of Japan's largest banks did merge to form colossal enterprises, the largest being Mizuho Holdings, Inc, composed of Daiichi Bank, Fuji Bank, and the Industrial Bank of Japan.[384]

FSA-Japan was accused of trying to manipulate the Nikkei 225 index through short sale restrictions, which were modeled after those of the SEC in the U.S.[385] Like the MoF, FSA-Japan has often been lenient, at least on Japanese banks. For example, FSA-Japan merely issued a warning to a Japanese bank that hid key information from inspectors.[386] FSA-Japan has shown that it does know how to play tough, at least where foreigners are involved. FSA-Japan accused two American firms of improper short sales, in another attempt to support the market.[387] In 1999, the Tokyo branch of Credit Suisse was excluded from engaging in the derivatives business in Japan after several abuses.[388] FSA-Japan denied the consequent claims that it was discriminating against foreign firms.[389]

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383. Pilling, *Japan May Move*, *supra* note 379, at 7.

384. Alexandra Nusbaum, *Investment Trust Hopes Lift Tokyo*, FIN. TIMES (London), Jan. 29, 2000, at 24.

385. *Some Securities Dealers Have Already Been Punished for Breaking Body*, ASAHI SHIMBUN, Mar. 19, 2002.

386. *Mizuho Given Warning in May for Misleading FSA*, ASAHI SHIMBUN, June 19, 2002.

387. David Ibison, *Nikkei Was Manipulated by Japan, Say Banks*, FIN. TIMES (London), June 13, 2002, at 1.

388. Michael S. Bennett & Michael J. Marin, *The Casablanca Paradigm: Regulatory Risk in the Asian Financial Derivatives Markets*, 5 STAN. J. L. BUS. & FIN. 1, 26 (1999). A criminal indictment was brought by Japanese prosecutors against the firm for concealing documents. Phred Dvorak & Erik Portanger, *London Division of Credit Suisse is Indicted in Tokyo*, WALL ST. J., Dec. 9, 1999, at A23.

389. Takeshi Uera, *Policies of Japan's FSA Misunderstood*, FIN. TIMES (London), June 18, 2002, at 14. Disciplinary action was also taken against JP Morgan by FSA Japan and against Nikko Salomon. Bayan Rahman, *JP Morgan Japan Arm Ban*, FIN. TIMES (London), Mar. 1–2, 2003, at 8; Jason Singer, *Japanese Regulators Penalize Nikko Salomon*, WALL ST. J., Mar. 19, 2003, at B10. American regulators have not been unwilling to employ a heavy hand in disciplining Japanese firms. *See* United States v. Iguchi, 1997 WL 593018 (2d Cir. 1997) (unpublished opinion) A Japanese rogue trader, who lost $1 billion in unauthorized trading, was jailed, and Daiwa Bank, the victim of this em-

The Nikkei 225 Index remains 74% below its high in 1989.[390] An advisory committee to FSA-Japan has recommended that stocks be sold at post offices as a means of shifting corporate financing away from bank loans and towards the equity markets in order to inflate the stock market.[391] The committee also supported a continuing role for the government in bailing out troubled banks.[392] The Bank of Japan followed up that proposal with an announcement that it would be buying the stock of companies held by banks.[393] This was said to be a "shocking" manipulation of the stock market designed for the benefit of the banks.[394] The Bank of Japan, FSA-Japan, and the MoF were said to be at an impasse over policy disputes.[395] On the positive side, the agency was seeking greater public disclosures from firms in precarious financial circumstances.[396] It raised its bank capital adequacy threshold for intervention and correction, but capital levels at Japanese banks were still well below the Basel minimum international standard.[397] FSA-Japan allowed banks to sell life and other insurance and announced that

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ployee, was fined $340 million for failing to report the losses promptly to U.S. regulatory authorities. That was then the largest criminal fine in history. *Id.*

390. Phred Dvorak, *Walking Wounded, One Reason Stocks in Japan Stay Low: Zombie Companies*, WALL ST. J., Aug. 28, 2002, at A1.

391. A proposal to reform the postal service was "emasculated." *Another Tokyo Setback*, WALL ST. J., Aug. 28, 2002, at A14. Japanese savings habits remain a matter of continuing concern. "The Japanese have a mammoth $122 trillion in household savings but invest just 4.4% of their financial assets in stocks, compared with about 18% for Americans." Dvorak, *supra* note 390, at A1.

392. *Panel Calls for Shift to Direct Financing*, JAPAN WKLY. MONITOR, July 15, 2002, *available at* LEXIS, IACNWS 89070940.

393. David Pilling, *Dramatic Action by BoJ to Shore Up Banks*, FIN. TIMES (London), Sept. 19, 2002, at 10; Phred Dvorak, *Japan's Central Bank Will Buy Stocks Held by Troubled Lenders*, WALL ST. J., Sept. 19, 2002, at A1. This led to a loss of confidence in the government's bond issues. Ken Belson, *Not Enough Bidders for Bond Auction*, N.Y. TIMES, Sept. 21, 2002, at C1.

394. *Japanese Central Bank Plans to Buy Stocks*, NEWS & OBSERVER (Raleigh), Sept. 19, 2003, at 3D.

395. Ken Belson, *Not Enough Bidders for Bond Auction*, N.Y. TIMES, Sept. 21, 2002, at C1.

396. *FSA Wants Companies to Disclose Vulnerability*, YOMIURI SHIMBUN DAILY YOMIURI, July 5, 2002, at 1.

397. *Watchdog Raises Bank Scrutiny*, ASAHI SHIMBUN, June 27, 2002. Large Japanese banks had capital of about one-fourth of that required by the Basel standard. *Hampered*, *supra* note 357.

it was allowing bank affiliated brokers to do so as well.[398] After some well publicized insurance firm failures, FSA-Japan increased regulatory controls over the industry, requiring, among other things, marked-to-market accounting and increasing solvency margins.[399] At the same time barriers to entry were being lowered, allowing some foreign competition.[400]

VIII. WHICH IS BETTER?

From a distance at least, the regulatory model developed by the U.K. has a great deal of theoretical appeal.[401] The different areas of the financial services industry have been gradually intermingling over the last quarter of a century. The American model of regulating each facet of finance is based on the historical separation of financial services and not on their current status. As Howard Davies, the Chairman of the FSA-UK, noted in answering his own rhetorical question of why his country should move to a super regulator:

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398. *FSA to Allow Bank's Securities Units to Sell Life Insurance*, JAPAN WKLY. MONITOR, June 24, 2002, *available at* LEXIS, IACNWS 87698011. *The Asahi Shimbun and Wire Reports*, ASAHI SHIMBUN, June 21, 2002; *Banking on Deregulation*, INS. DAY, May 3, 2001, at 4.

399. *Japan's FSA Tightens Up Sector Regulation*, INS. DAY, Apr. 26, 2001, at 5. A self-assessment system was implemented for setting reserve requirements. Hino Address, *supra* note 362, ¶ 16. Japanese insurance companies continued to experience a loss in profitability as a result of the disinflation in the economy. *Insurers Must Abandon Herd Mentality*, YOMIURI SHIMBUN DAILY YOMIURI, June 11, 2002, at 1, 1–2. The industry was consolidating. *See Outlook on Japan life Insurers Remains Negative*, PR NEWSWIRE, June 7, 2002, *available at* http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=105&STORY=/www/stroy/06-06-2002/0001742568; *Life Insurers Plan Pension Fund Management Alliance*, BESTWIRE, Apr. 10, 2001. FSA-Japan has allowed mergers of life and non-life insurers, aiding the trend toward consolidation. Bayan Rahman, *Dai-Ichi and Yasuda Moot 316 Billion Dollar Link*, FIN. TIMES (London), Aug. 28, 2000, at 20; *One Result of Japan's Big Bang. . .* , INS. DAY, Oct. 2, 2001, at 9.

400. Charles Garnsworthy, *Life Crisis Prompts Change*, REINSURANCE MAG., May 1, 2002, at 26; *A Growing Influence on the Japanese Scene*, INS. DAY, Dec. 6, 2000, at 7.

401. The super regulator is becoming an increasingly popular model. Germany only recently created a single regulator — the Federal Agency for Financial Services Supervision. G. Thomas Sims, *Germany Wants New Regulator to Boost Confidence*, WALL ST. J., May 2, 2002, at A13. South Korea also created a Financial Supervisory System as a unified regulator. Andrew Ward, *UBS and Merrill Punished for Leaks,* FIN. TIMES (London), Aug. 14, 2002, at 17.

> Because financial markets move on, the sectoral system put in place in the late 1980s is no longer fit for the purpose at the beginning of the 21st century. The old divisions between banks, insurance companies, securities firms, investment managers, and the rest, do not reflect the way the financial sector is now organized. Banks own insurance companies, and vice versa. Insurance companies own fund managers. The most rapidly growing mortgage bank is owned by a mutual life insurer. Lloyds TSB now incorporates Scottish Widows. What do you call Citigroup, which includes Citibank, Travellers, Salomon Smith Barney and, now, Schroders?[402]

Nowhere is this trend more evident than in the U.S.. It is best exemplified by the Chairman's reference to Citigroup,[403] a modern financial services firm that sells products across all business lines.[404] There are few, if any, remaining conventional banks that only take deposits and make loans, surviving on the spread.[405] Merrill Lynch is, for example, not just a broker-

402. Howard Davies, *Scrutiny has Sharpened Resolve of City Watchdog*, TIMES (London), May 2, 2000, at 26.

403. International financial behemoths such as Citigroup raise other concerns:

> Who regulates Citigroup, the world's largest and most diverse financial institution? With its operations in over 100 countries, selling just about every financial product that has ever been invented, probably every financial regulator in the world feels that Citi is, to some degree, his problem. . . . Yet in a sense nobody truly regulates Citi: it is a global firm in a world of national and sometimes sector watchdogs. The same is true of AIG, General Electric, UBS, Deutsche Bank and many more.

The Regulator Who Isn't There, ECONOMIST, May 18, 2002.

404. Banks now sell 40% of the annuities sold in the U.S.. Jeff D. Opdyke, *A Risk-Free Way to Beat the Dow?,* WALL ST. J., Aug. 28, 2002, at D1.

405. As a 1995 U.S. Treasury memorandum also noted with respect to the traditional banking business:

> The share of total private financial assets held by insured depository institutions has declined sharply, from about 60 percent in 1970 to less than 35 percent today.
>
> Only 15 percent of all financial assets held by households and the non-profit sector in 1994 was accounted for by insured deposits.
>
> Recent data show that, of the 20 largest financial firms in the United States. Only 5 are commercial banks. Moreover, a number of diversified financial services firms own non-bank, thrift institutions, or industrial loan companies.

dealer. It sells insurance, provides bank services, manages portfolios, and engages in a wide range of financial services that compete with those of the large banks.[406]

The single regulator approach provides FSA-UK with the ability to approach financial regulation from a larger perspective. The agency is able to focus on those objectives and to decide how they can be met in the most rational fashion, rather than through competition with other regulators.[407] As a single regulator, the FSA-UK can be refreshingly candid about what it

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> The differences between the products of banks and non-bank financial firms have been increasingly blurred. The emergence of similar products by different firms operating under different regulatory regimes results in complicated competitive and regulatory issues.
>
> A number of commercial banks engage in little or no traditional banking — funding commercial loans with deposits. Rather, they specialize in trading activities, consumer finance, or fee-based services.
>
> Capital markets have become increasingly globalized, and financial markets in different countries have become more interdependent.
>
> Technological innovations such as remote banking and digital cash daily redefine the nature and delivery of financial services and the respective roles played by bank and non-bank firms. For example, the date processing firm EDS is the second largest owner/operator of ATMs in the U.S.

DEPARTMENT OF THE TREASURY, MEMORANDUM FOR MEMBERS OF THE SECRETARY'S ADVISORY COMMISSION ON FINANCIAL SERVICES FROM JOAN AFFLECK-SMITH, DIRECTOR, OFFICE OF FINANCIAL INSTITUTIONS POLICY (Oct. 23, 1995) [hereinafter DOT, MEMO ON FINANCIAL SERVICES].

406. As Merrill Lynch notes:

> The financial services industry continues to be affected by an intensifying competitive environment, as demonstrated by consolidation through mergers and acquisitions, competition from new and established competitors using the Internet or other technology, and diminishing margins in many mature products and services. The trend of consolidation of commercial and investment banks made possible by the Gramm-Leach-Bliley Act has also increased the competition for investment banking business through the use of lending activities in conjunction with investment banking activities.

MERRILL LYNCH, 2001 ANNUAL REPORT 17, *available at* http://www.ml.com/annualmeetingmaterials/annrep2001/ar/discussion.html.

407. The FSA-UK has taken this ability seriously and has thoughtfully addressed its statutory objectives and how they can be met. FINANCIAL SERVICES AUTHORITY, 2002 A NEW REGULATOR FOR A NEW MILLENIUM (Jan. 2000), *available at* http://www.fsa.gov.uk/pubs/index-chrono-2000.html.

is able to accomplish, advising the public that it "does not aim to prevent all failure" and that it "recognizes the proper responsibilities of consumers themselves and of firms own management and the impossibility and undesirability of removing all risk and failure from the financial system . . . ."[408] There is, however, an important factor present in the U.K. that is not found in Japan, the other super regulator country considered in this Article. There is a long and well developed culture in the U.K. of avoiding governmental interference in business.[409] The FSA-UK, while reflecting a political demand for more regulation, is still a non-governmental body that remains an extension of the City's cultural abhorrence to intrusive regulation. London has learned from long experience that, while there will always be scandals and failures, each should be viewed as *sui generis* and dealt with accordingly.

Japan, in contrast, has a regulatory culture of intervention and economic management. The MoF managed the economy with some success in its early stages; Japan even threatened the U.S. competitively.[410] That MoF model, while successful during the growth period of the Japanese economy, failed as the economy became more complex.[411] The insular nature of Japan's financial structure crumbled in the face of global competition that the country could no longer avoid. Mounting scandals, which were unearthed as the economy declined, required that the MoF be removed at least from the front door of regulation. The creation of FSA-Japan gave lip service to finding market

408. INTRO. TO THE FSA, *supra* note 295, at 7.

409. *See* Schooner & Taylor, *supra* note 275, at 613 (describing the reasons for this hands-off culture).

410. *See generally* DAVID HALBERSTAM, THE RECKONING (1986) (describing the competitive threat to American automobile manufacturers from Japan).

411. This is a point best left to the economists, but it seems that managed and command economies may do well in their early growth stages and then collapse as the economy becomes too complex for such management. The most extreme example is the former Soviet Union. The country's economy recovered to its pre-World War II levels within five years of the conclusion of that conflict despite the damage wreaked by the Germans. Its economy continued to expand for a time before falling apart. At the end, eighteen million bureaucrats were trying to substitute for a market. The result was shortages in 234 out of 277 basic consumer goods. Alexander Belozertsev & Jerry W. Markham, *Commodity Exchanges and the Privatization of the Agricultural Sector in the Commonwealth of Independent States — Needed Steps in Creating a Market Economy*, 55 LAW & CONTEMP. PROBS. 119, 128–31 (1992).

solutions to the economic malaise in Japan, but that agency still seems to cling to the culture of managing the economy by supporting large banks and resisting foreign competition. Consequently, the Japanese super regulator model does not seem to be a desirable one to mimic. A developed economy is simply too complex to be managed by bureaucrats, no matter how brilliant.

This brings us to the American competitive regulatory model. The GLBA enshrined the concept of "functional" regulation, which means that a diversified financial services firm that has a bank in its holding company structure will have a plethora of regulators with substantively different and sometimes conflicting regulatory requirements. Such a firm will face regulation from several bank regulators, including the Federal Reserve Board, the FDIC, and either the Comptroller of the Currency or a state bank regulator. The firm will also be regulated by the CFTC and the SEC, plus one hundred or more state securities and insurance commissions.[412] The firm will further be subject to regulation by various self-regulatory organizations, including NASDR, probably the NYSE, various options exchanges, the National Futures Association, and possibly various contract markets such as the Chicago Board of Trade. If that were not enough, such entities must also undergo the scrutiny of an ever-increasing list of "gatekeepers," including accountants, lawyers, analysts, NRSROS, and outside directors. The Federal Trade Commission is using its cold calling and false advertising regulatory powers to appear in joint "sweeps" with the SEC and CFTC.[413] There are also state attorney general wolf packs and an increasingly aggressive Justice Department that will happily destroy a large firm and devastate its employees' careers because of the wrongdoing of a few.[414] What exactly is functional about this morass?

The American regulatory culture is an aggressive one, reflecting a strong anti-business bias.[415] In the context of the SEC and

412. The District of Columbia must also be counted.

413. *See supra* note 259. The FTC was also seeking a $215 million fine from Citigroup, perhaps the most regulated firm in the world, for predatory lending practices. *Citigroup to Settle Lending Case*, N.Y. TIMES, Sept. 20, 2002, at C12; *What's News*, WALL ST. J., Sept. 6, 2002, at A1.

414. *See infra* notes 424–25, 433 and accompanying text.

415. The author has tried to catalogue this cultural bias elsewhere. It can be traced at least to Thomas Jefferson's antipathy to the northern merchants, and was fueled by Andrew Jackson's destruction of the Bank of the U.S. and

CFTC, there are numerous instances of this aggressiveness. Insider trading prosecutions are a prime example. Such charges have not been vigorously pursued in Tokyo or London.[416] The Sumitomo copper case also makes an interesting case study. Sumitomo Corp., a large Japanese trading company, was the victim of a rogue trader who was manipulating the world copper market, mostly through trading conducted in the London markets. The unauthorized activities of this trader, Yasuo Hamanaka, cost Sumitomo $2.6 billion in trading losses, a rather severe punishment in and of itself. Despite the fact that Hamanaka's trading had only a tangential relationship to the U.S., the CFTC brought a case against Sumitomo and fined

the excesses of the Robber Barons. The harsh competition practiced by the trusts also gave it strength. The "populists," the "muckrakers," and the "money trust hunt" laid the groundwork for the New Deal financial legislation that was anti-business in its thrust and which is popularly viewed, without any apparent justification, to have saved America during the Great Depression. The questionable payment scandals of the 1970s and the insider trading scandals of the 1980s caused a rebirth of the anti-business movement in American culture. *See* 1–3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* notes 15, 42, 274. Now Enron has freed these demons once again.

416. An FSA-UK official stated that he could "count the number of U.K. insider-trading cases on the fingers of one hand, 'and still have a few to play with.'" Anita Ragahaven et al., *Europe's Police Are Out of Luck on Insider Cases*, WALL ST. J., Aug. 17, 2000, at C1. Japan was even more of an "insider's paradise." Laurence, *supra* note 281, at 670. Japan has been prodded into being more vigorous against insider traders. Between 1992 to June 2001, the SESC filed thirty-six cases with the prosecutor, thirteen of which involved insider trading. Securities and Exchange Surveillance Commission, *What We Do*, *at* http://www.fsa.go.jp/sesc/english/actions/actions.htm (last visited Jan. 30, 2003). These regulators have also responded to other SEC initiatives. The FSA-UK adopted the SEC view on selective disclosure to analysts. *See, e.g.*, Silvia Ascarelli, *U.K. to Bolster Rules That Bar Select Briefings with Analysts*, WALL ST. J., Oct. 26, 2000, at A21 (describing the FSA-UK's views). In doing so, however, the FSA-UK allowed its firms to take corrective actions and noted that market forces were requiring the change in any event. Randall Smith & Aaron Luchetti, *How Spitzer Will Affect Wall Street*, WALL ST. J., May 22, 2002, at C1. The FSA-UK has also been more gingerly than the SEC in its approach to the regulation of electronic communications networks. Silvia Ascarelli, *U.K. Regulators Seek Advice on Ways to Oversee Electronic Trading*, WALL ST. J., Jan. 24, 2000, at C22; Mark Atherton, *FSA Reviews Share Deal Rules*, TIMES (London), Apr. 26, 2001, at 28. Both Japan and the U.K. have expressed concern that the Sarbanes-Oxley legislation has gone too far and could adversely affect their companies. *See, e.g.,* Edward Alden, *Japan Joins Chorus of Disapproval on New U.S. Corporate Rules*, FIN. TIMES (London), Aug. 1, 2002, at 6.

the company a record amount of $150 million. Japan and the U.K. only piggybacked onto this action. Japan prosecuted the rogue trader. Most of the trading at issue took place in London, but the FSA-UK asked only for its costs in investigating the matter, some $8 million.[417]

The Enron affair and subsequent accounting scandals underscore the weakness and instability of this competitive regulatory culture, particularly when politics intervene.[418] Competitive regulation did not stop any of these massive accounting frauds.[419] The hysteria attending the Enron affair in Congressional hearings was another appalling chapter in our financial history.[420] Berating and badgering witnesses, demanding only

417. Aaron Lucchetti, *CFTC Fines Sumitomo a Record $150 Million*, WALL ST. J., May 12, 1998, at C19. *See also* In the Matter of Sumitomo Corp., [1996–1998 Transfer Binder] Commodity Futures L. Rep. (CCH) ¶ 27,327 (C.F.T.C. 1998) (CFTC consent decision).

418. These scandals turned on various schemes to manage or falsify earnings, a concern that has been around for decades. George Getschow, *Paper Profits, Slick Accounting Ploys Help Many Companies Improve Their Income*, WALL ST. J., June 20, 1980, at 1. In 1999 — before Enron — the SEC had been investigating managed earnings. Thomas S. Mulligan, *New Wave of Accounting Probes Deepens Fear*, L.A. TIMES, Apr. 4, 2002, at C1. Concern with accounting practices is also an old issue. *SEC Chief Urges Accountants to Improve Self-Regulation or Risk U.S. Intervention*, WALL ST. J., Jan. 4, 1980, at 11. *See also* Charles Stabler, *Accountants' Self-Regulatory Efforts Get SEC Praise, But Further Steps Are Urged*, WALL ST. J., July 6, 1978, at 4 (SEC submits massive 1,300 page report on accounting profession to Congress).

419. *See, e.g.*, Anita Raghavan et al., *Full Speed Ahead: How Enron Bosses Created a Culture of Pushing Limits*, WALL ST. J., Aug. 26, 2002, at A1 (describing guilty plea by an Enron financial officer); Sheila McNulty & Peter Spiegel, *Former Enron Executive Pleads Guilty to Fraud Charges*, FIN. TIMES (London), Aug. 22, 2002, at 23 (same). *See also* Elizabeth Douglas et al., *The Nation, Former Phone Execs Arrested*, L.A. TIMES, Aug. 2, 2002, at A1 (describing the WorldCom fraud).

420. The newspapers joined this lynch mob with enthusiasm. *See, e.g.,* Raghavan et al., *supra* note 419 (describing Enron executives as bad boys who went to strip bars, drove fast cars, and paid $500 per month for a parking spot). Of a kin was an English author's supercilious suggestion that Enron and other accounting scandals might evidence that Karl Marx was correct in claiming that capitalism was victimizing society. Niall Ferguson, *Marx, Niall Ferguson Says Capital's Author was Right about the Class Struggle*, FIN. TIMES (London), Aug. 17, 2002, at 1. The low was reached in the "Women of Enron" photo spread in the August 2002 issue of *Playboy*. *See Women of Enron*, PLAYBOY, Aug. 2002, at 118. At that point, all that was lacking was an article in the *National Enquirer* claiming that the Enron executives were children of aliens from outer space. The gap was filled when the scandal over

yes or no answers to convoluted and complex questions, mocking witnesses and cutting off their answers when it was not favorable to the Congressional inquisitor, and requiring witnesses to take the Fifth Amendment in front of cameras had all the trappings and foulness of a McCarthy era hearing.[421] The SEC

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whether Martha Stewart, the guru of domestic living, had engaged in insider trading in ImClone Stock. The mob positively howled. *See, e.g.,* Holman Jenkins Jr., *Business World: An Autumnal Resolution: Give Martha a Break*, WALL ST. J., Sept. 4, 2002, at A23 (describing the allegations). The scandal over Jack Welch's retirement benefits set off another feeding frenzy. Despite the fact that he had added billions of dollars of value to General Electric, the press was claiming he had acted improperly after it was revealed in a divorce case that he was given perquisites valued at about $2.5 million per year. Those perks included such things as tickets to sporting events, and the opera, a small consulting fee, an apartment, office, and use of a corporate jet, all of which had been negotiated with outside directors and disclosed. *See, e.g.,* Matt Murray et al., *GE Pact With Welch Raises Eyebrows*, WALL ST. J., Sept. 9, 2002, at B4; Jack Welch, *My Dilemma and How I Resolved It*, WALL ST. J., Sept. 16, 2002, at A14. These two celebrities were not the only targets of the press. One of the more silly charges claimed that a Merrill Lynch analyst was somehow corrupted by an exchange of wine and champagne with the CEO of Tyco, who was later indicted for tax evasion and looting Tyco. *See, e.g.,* Patrick McGeehan, *Lawyer Says Ex-Merrill Analyst Traded Gifts with Tyco Chief*, N.Y. TIMES, Sept. 14, 2002, at C1.

421. The fact that a great many people seem surprised that a severe market downturn would expose abuses is beyond comprehension, particularly after an unprecedented ten-year bull market that predictably covered up a multitude of sins. The dismay expressed for the 5,000 or so laid-off Enron employees and even Enron shareholders also seems somewhat affected, when one considers the fact that Motorola, Nortel, Corning, Lucent, and Procter & Gamble have each laid off tens of thousands of employees in the last few years. There were no cries of outrage when those employees were left without a job. These companies' shares, many of which were held in employee 401(k) accounts, sustained major losses, but there were few cries to lynch the executives. *See, e.g.,* Richard Waters, *Nortel Spasm Causes Pain for Sector Rivals*, FIN. TIMES (London), Aug. 29, 2002, at 1 (describing the continuing problems in the telecom industry). The difference in the case of Enron was the result of several factors that went beyond a concern for fraudulent accounting practices, as serious as they may be. The stock market was falling in 2001, and the Enron collapse was a signal to find a scapegoat for that downturn. This was also a political opportunity. The Democrats could not attack President Bush over the "War on Terror," so they turned to the economy and Enron. The Republicans could not let the Democrats out-Enron them since the coming elections would decide control of Congress by one party or the other. The Republicans became as strident as the Democrats as this quickly turned into an election issue. *See, e.g.,* John Harwood & Shailagh Murray, *Guns and Butter: For Fall Campaigns, a Tension between Economy and Security*, WALL ST. J., Aug. 30, 2002, at A1; Jeff Zeleny, *Democrat Hopefuls Dig in on Economy; Moderates*

joined the witch-hunt, requiring the CEOs of America, guilty or not, to take a loyalty oath to full disclosure by swearing to the accuracy of their company's financial statements.[422] Hastily drafted legislation led to an incredible increase in the SEC's budget and more redundant layers of regulation were added.[423]

Competitive regulation, at least in a crisis, results in bad judgment of an extreme character. Exhibit A is the Justice Department's indictment and trial of Arthur Andersen, LLP.[424] Tens of thousands Arthur Andersen employees worldwide, far outnumbering the affected Enron employees, were forced to find new jobs even though they did not participate in the alleged wrongdoing of the one individual found responsible for the conviction of the firm.[425] The conviction also badly damaged Enron

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Warn Attacks on Business Could Backfire, CHICAGO TRIBUNE, July 9, 2002, at N9.

Corporate accountability even became an issue in gubernatorial contests, as if the governors could do anything about SEC accounting issues. *See, e.g.*, Randal Archibold, *Cuomo is Saving His Firepower For End of Race, Advisers Say*, N.Y. TIMES, Aug. 22, 2002, at B6 (New York race); Mark Z. Barabak, *Bush Steps Carefully Into State*, L.A TIMES, Aug. 23, 2002, at A1 (California race). Of course, corporate accountability is not a new issue, having arisen in the questionable payment scandals of the 1970s. *See, e.g.,* Stan Crock, *Manager's Journal*, WALL ST. J., Mar. 13, 1978.

422. *See* Andrew Hill, *Wall Street's Next Focus is 'Oath' Deadline*, FIN. TIMES (London), Aug. 5, 2002, at 19. In the end, only sixteen of the 691 reporting companies required to take this oath were unable to certify their financial statements. Krissah Williams, *16 of 691 Firms Missed Deadline; SEC is Undecided on Consequences*, WASH. POST, Aug. 22, 2002, at EO3.

423. *See supra* notes 71–80 and accompanying text.

424. Arthur Andersen, LLP was Enron's auditor. The accounting firm was indicted and later convicted of obstructing justice by trying to cover up certain improper accounting practices. *See generally* ENRON CORP., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (2002). Arthur Andersen had also been found liable in some earlier accounting scandals, and the company was effectively destroyed after its conviction. *See, e.g.,* Flynn McRoberts, *Verdict No Boon for Enron Plaintiffs*, CHI. TRIB., June 18, 2002, at 1 (describing effects of verdict).

425. The verdict in the Andersen case was extremely bizarre. The Justice Department had charged Arthur Andersen with obstruction of justice based on document shredding by an accountant in the Houston office, who had pled guilty to wrongdoing. The jury, however, convicted the firm on the basis of a memorandum written by an Andersen attorney on another issue. *See, e.g.,* Kurt Eichenwald, *Andersen Team Weighs Asking Judge to Undo Guilty Verdict*, N.Y. TIMES, June 19, 2002, at C1. The Andersen attorney had testified at length before Congress concerning the memorandum in question. The issue was again raised during the Andersen trial, after the government's star wit-

investors. A settlement proposal by Arthur Andersen of $750 million, to be paid substantially out of future revenues, was presumably only an opening bid and was rejected by class action plaintiffs; it was reduced to $375 million as the government's indictment approached. That too was taken off the table after the conviction, and plaintiffs are now negotiating a $60 million settlement from the parent company of Arthur Andersen, LLP.[426] Further recoveries from the convicted auditing firm are problematic, since it is forfeiting its right to practice, cutting off future revenues that could have been used to compensate investors and Enron employees.[427]

The disclosure of other accounting frauds witnessed Gestapo-like dawn raids on the homes of corporate executives. Businessmen, whose only violent act in their entire lives was perhaps an attack on a tennis ball, were manacled and frog-marched before news cameras during their "perp walk."[428] This was a particularly sordid adjunct to this whole affair.[429] The

ness turned out to be favorable to the defense. The Andersen attorney, however, was kept off the stand and could not testify in Andersen's defense because the Justice Department had sent her a target letter. *See, e.g.,* Greg Burns, *Who is Nancy Temple?*, NEWSDAY, June 30, 2002, at FO1.

426. Forty million dollars of this amount was for Enron investors and the rest is for creditors. Peter Spiegel, *Andersen Worldwide in $60 Million Settlement over Enron*, FIN. TIMES (London), Aug. 28, 2002, at 17.

427. Mitchell Pacelle & Cassell Bryan-Low, *Andersen Worldwide Sets Likely Deal*, WALL ST. J., Aug. 28, 2002, at C1. The frenzy over the corporate scandals arising from the Enron debacle cost the American economy an estimated $35 billion, an amount equal to a rise in oil of $10 per barrel of oil. *World*, FIN. TIMES (London), Sept. 5, 2002, at 1.

428. WorldCom and Adelphia executives were among those given the "perp walk" treatment. *See, e.g.,* Joshua Chaffin et al., *Ex-WorldCom Chiefs Arrested*, FIN. TIMES (London), Aug. 2, 2002, at 1. The manacling and parading of the seventy-eight year old non-violent founder of Adelphia before the assembled press and cameras was particularly obscene, drawing a protest from the New York Civil Liberties Union. *See, e.g.,* Fred O. Williams, *Adelphia Creditors Object to Rigas Loans*, BUFFALO NEWS, Aug. 14, 2002, at B5. *See also* Lauro v. Charles, 219 F.3d 202 (2d Cir. 2000) (staged "perp walk" violated Fourth Amendment).

429. *See Those CEO Perp Walks*, WALL ST. J., Aug. 20, 2002, at A18 (objecting to this practice); Herbert J. Hoelter, *The Corporate Scandals*, NEWSDAY, Aug. 25, 2002, at BO4 (same). In contrast to the treatment given these executives, a federal judge has held the New York City government in contempt for not providing hearings to inmates previously found with weapons before handcuffing them for transportation. Such inmates must be given an opportunity to show they are not violent before they are shackled and must be al-

pillory was an ancient punishment that has been long banned for all crimes, except, it now appears, for financial ones.[430] A conviction is not even required before this punishment is applied to corporate executives. If this were not enough, New York Attorney General Eliot Spitzer showed up to conduct his own sideshow,[431] demanding a $100 million fine from Merrill Lynch before turning to others in an effort to create a regula-

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lowed to establish whether the shackling is harmful to their health. Fines imposed on the city for violating those requirements are to be credited to the inmates' own accounts. *See, e.g.*, Cerisse Anderson, *Correction Department Found in Contempt Over Handcuffing*, N.Y. L.J., Sept. 27, 2002, at 1.

430. The pillory was a popular punishment meted out by the Star Chamber in England for economic crimes. For example, in 1630, an individual found guilty of forestalling, (i.e., holding goods off the market in hopes of creating a shortage and causing prices to rise), was required to stand in the pillory at New Gate Market with a sign affixed to his hat identifying his crime. REPORTS OF CASES IN THE COURTS OF STAR CHAMBER AND HIGH COMMISSION 42–43 (Samuel Rawson Gardiner ed., 1965). The long abolished medieval crimes of engrossing, regrating, and forestalling have also been brought back to punish corporations. *See, e.g.,* Sheila McNulty, *FERC Judge Says El Paso United Acted Illegally in Energy Crisis*, FIN. TIMES (London), Sept. 24, 2002, at 1 (Administrative Law Judge at Federal Energy Regulatory Commission finds company withheld supplies from market in order to obtain higher price).

431. There is some precedent for Attorney General Spitzer's crusades. Indeed, lest you think that the Enron scandal and other recent business contretemps are unique, the American Ice Company scandal at the beginning of the twentieth century had all the elements of those episodes and a pardon scandal to boot. Like Enron, the American Ice Company made large amounts of contributions to politicians and engaged in questionable accounting practices. Like Enron, it was one of the largest companies in the U.S. before it was consumed in scandal. Its monopoly over a vital consumer product at the beginning of the twentieth century was so complete that, at least in comparison, Microsoft might be likened to a benevolent society for the protection of competitors. Like Merrill Lynch, the American Ice Company was the target of a crusading New York attorney general. A presidential pardon of the American Ice Company's president was as controversial as Bill Clinton's pardon of Marc Rich. *See* DAVID HEMENWAY, PRICES & CHOICES, MICROECONOMIC VIGNETTES 189 (3d ed.1993) (describing the American Ice Company scandal). *See also Ice Trust Declared to be Unlawful*, N.Y. TIMES, May 25, 1900, at 1 (describing attorney general's action against the American Ice Company); Robert C. Kennedy, *Hunting the Octopus*, N.Y. TIMES, May 27, 2002, at http://www.nytimes.com/learning/general/onthisday/harp/1006.html (last visited Mar. 20, 2003) (describing the political fight over the Ice Trust Case); *Antitrust Prosecutions*, N.Y. TIMES, Jan. 7, 1912, at 32, 32–33 (survey of antitrust actions by state attorney generals).

tory empire on Wall Street over stock analysts.[432] This led to another campaign by a newly formed wolf pack composed of forty state regulators.[433]

Competitive regulation inevitably means more regulation. For some reason, there are never quite enough regulatory tools in the drawer. Each scandal results in a claim by the regulator

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432. Attorney General Spitzer continued his quest, focusing on Jack Grubman, an analyst at Salomon Smith Barney. Spitzer was investigating a practice called "spinning," i.e., allocating shares in a hot IPO to officers of other clients in order to gain underwriting business. *See generally* Randall Smith & Susan Pulliam, *Buddy System: How a Technology-Banking Star Doled Out Shares of Hot IPOs*, WALL ST. J., Sept. 23, 2002, at A1. Such practices had been the subject of regulatory concern since at least 1997, but there were no headlines in it for the attorney general to intervene while the market was trending upward. Michael Siconolfi, *NASD Warns on "Spinning" IPO Shares*, WALL ST. J., Nov. 24, 1997, at C1; *The Motley Fool Column*, ST. LOUIS POST DISPATCH, Apr. 20, 1998, at BU6. Not to be outdone by Spitzer, Congress announced its own hearings. Tom Hamburger et al., *Salomon IPO Deals Provoke Congress*, WALL ST. J., Aug. 29, 2002, at C1. But Spitzer was already on to bigger game — Citigroup — giving rise to speculation that he may even be after Sandy Weill, the head of Citigroup. Charles Gasparino, *Inquiry Into Salomon Widens to Include Possible Weill Role*, WALL ST. J., Aug. 23, 2002, at A1; Joshua Chaffin & Gary Silverman, *Spitzer Subpoena for AT&T Files*, FIN. TIMES (London), Aug. 24, 2002, at 10.

Spinning was not new to Wall Street. The preferred lists of J.P. Morgan & Co. had been condemned at length in the hearings that led to the enactment of the federal securities laws. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 145–46. Does this mean all of this regulation has been for nothing? In another remarkable episode, the *Financial Times* of London announced that executives made $3.3 billion before the failure of their companies, which included Enron, WorldCom, and Global Crossings. Len Cheng, *3.3 Billion Dollars for Executives of Failed Companies*, FIN. TIMES (London), July 31, 2002, at 1. Spitzer then announced that he would be investigating those executives for receiving that compensation. Lionel Barber & Gary Silverman, *NY State Attorney Probes Awards to Heads of Bankrupt Groups*, FIN. TIMES (London), Aug. 1, 2002, at 1.

433. The SEC sought to compete by launching its own investigations. *See* Michael Schroeder, *States' Wall Street Probe Bogs Down*, WALL ST. J., Sept. 13, 2001, at C5. The analysts' investigations resulted in a spectacular $1.4 billion joint settlement between several large investment banks and state and federal securities regulators. *See generally* Charles Gasparino, *Analyst Pact is Held Up by Words*, WALL ST. J., Jan. 16, 2003, at C1. Citigroup alone paid $450 million in that settlement. Randall Smith, *Regulators Set Pact, But Some Issues Still Remain*, WALL ST. J., Dec. 23, 2002.

The state attorney generals were also using their new found power to press businessmen for campaign contributions. Tom Hamburger & Michael Schroeder, *The Economy: Spitzer Heads Bill at Campaign Event for Attorney Generals*, WALL ST. J., Oct. 4, 2002, at A2.

involved that it needs more regulatory power and additional rules are adopted, even though library shelves are already filled with statutes and regulations so complex that some law school professors spend their entire careers studying those promulgated by just one agency. A further layer of regulation is always needed after each scandal, even though a simple fraud prohibition would cover nearly every misdeed of concern. But competing agencies have a vested interest in scandals. Scandals allow the regulators to claim they need more resources; they allow the agencies to grow, expand, and compete more forcefully with other agencies.

Of course, we must be careful of what we wish for in life. A single regulator may also seek to expand its powers after a scandal. A single regulator will also undoubtedly use bad judgment in times of crisis. A single regulator could also stifle competition, over-regulate, and cause a loss of competitive position in international markets.[434] It could even try to become a Japanese MoF that seeks to manage the economy by bureaucratic fiat. There would be no competition to prove which regulator can be the most aggressive. There would be no pressure for more resources in order to best a competing regulator.[435]

It may also be argued that competition leads to less restrictive regulation, at least for some market participants. A case in point is the CFTC and SEC. The futures industry has enjoyed low margins, no suitability requirement, little insider trading restrictions, etc. If a monolithic agency with an SEC viewpoint had been in place, such regulatory burdens would probably not have been avoided. Of course, if the single regulator had a CFTC viewpoint, the securities industry's burdens might have been eased. Another argument is that the regulatory wars between the CFTC and SEC diverted the attention of these agencies and allowed the over-the-counter derivatives industry to develop. While this may be true, that development was still

434. These concerns are described at greater length in Markham, *Banking Regulation: Its History and Future, supra* note 4, at 272–85.

435. A Task Group on Regulation of Financial Services chaired by Vice-President George H. Bush in 1984 cautioned that "[t]hroughout American history, no single government authority has ever been entrusted with regulatory authority over all American banks." BLUEPRINT FOR REFORM, *supra* note 1, at 8.

impeded by the CFTC's defense of the contract market monopoly, which led to much derivatives business moving abroad.

The federal securities laws and the Commodity Exchange Act need to be revisited and revised from the ground up. The regulatory structure imposed in the 1930s was directed at a market far different from the one that exists today.[436] There has been a massive transformation of the financial markets[437] — history has simply outstripped regulation. Financial service firms now cross all product lines. As the Treasury Department has noted: "[I]n light of the changing market shares, the emergence of new financial products and technology, and the disintegration of traditional industry and product lines . . . there needs to be a fundamental reassessment of why and how we regulate financial firms."[438]

Traditional broker-dealers and futures commission merchants are nearly extinct. Broker-dealers are selling insurance, making loans, and looking very much like banks.[439] Broker-dealers, as well as banks, are also selling insurance. Insurance companies are reinventing themselves and becoming diversified financial services firms.[440] Financial engineering has melded commercial and investment banking together, a fact now recognized by GLBA. The futures commission merchant business has evolved into an over-the-counter derivatives dealer. Derivatives and securities products are being blended. Moreover, financial services are becoming a global business, in which American firms must compete with large international firms that cross-sell financial products and are subject to much

436. The regulatory burdens imposed on financial firms are the result of accumulated abuses over the years. The incongruity of many of those regulations is obvious. The non-violators must bear the regulatory burdens for the conduct of the miscreants. The innocent are punished long after the guilty have left the scene.

437. *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215.

438. DOT, MEMO ON FINANCIAL SERVICES, *supra* note 405 (italics omitted).

439. The Merrill Lynch Cash Management Account provides all the benefits of a bank account, as well as those of a brokerage account. *See* Paine, Webber, Jackson & Curtis, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 564 F. Supp. 1358, 1361–62 (D. Del. 1983).

440. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 235–36.

lighter regulation than that found in the U.S.[441] Electronic trading offers further challenges. Another concern is the internationalization of financial services. The confusion, complexity, and costs associated with multiple regulators will certainly place U.S. financial institutions at a severe competitive disadvantage with European and even Japanese firms that operate under a single regulatory umbrella.

Technology is removing much of the structure on which our current functional regulatory system is based. Technology provides a means to bypass traditional intermediaries such as the exchanges, banks, and broker-dealers. Institutional investors may use Instinet or other ECNs to avoid paying the spread on a NASDAQ or a NYSE listed security; securities customers need not pay a large commission to a broker-dealer to execute an order. Rather, it can be done online relatively cheaply. Insurance agents are being circumvented through online purchases.

441. A single regulator would also facilitate coordination among regulators on an international level, a need underscored by the BCCI debacle. The Basel Committee and the International Organization of Securities Commissions ("IOSCO") are currently coordinating such regulation, but their roles are simply placed on top of the mass of regulators in the U.S. The growth of international exchange linkages and electronic trading is also raising the stakes for those regulators. Conflicts are also occurring at the international level. *See, e.g.*, Compliment, *European Companies With UD Listing Fail to Escape Sarbanes-Oxley Act*, *at* http:/www.compliment.com/securities-uk/dailynews/ (last visited Aug. 30, 2002) (describing objection by European Union to requirement that Europeans swear to the accuracy of their financial statements before a U.S. agency); Lydia Adetunji, *SEC Votes to Include Foreign Company Chiefs*, FIN. TIMES (London), Aug. 28, 2002, at 7 (describing SEC indifference to those concerns). The European Union is also posing regulatory challenges through its financial directives that seek a single European market in financial services. *See generally* Jennifer Manvell Jeannot, Comment, *An International Perspective on Domestic Banking Reform: Could the European Union's Second Banking Directive Revolutionize the Way the United States Regulates Its Own Financial Services Industry*, 14 AM. U. INT'L L. REV. 1715, 1732–33, 1738 (1999) (noting that the European Union seeks harmonized regulation as a way to improve the competitive position of banks in member countries); James Mackintosh, *Regulator to Warn Against Brussels Boardroom Plans*, FIN. TIMES (London), July 30, 2002, at 14 (expressing concern that European Union financial directive could weaken corporate governance standards, which are claimed to be higher than those in the U.S.); Erik Portanger, *Politics and Pride Slow Drive for Pan-European Securities Regulator*, WALL ST. J., Aug. 17, 2000, at C7 (discussing need for a pan-European regulator in light of the merger of several European stock exchanges and political obstacles to such regulation).

Loans and other commercial bank services are also being marketed outside traditional bank channels.

There are serious political roadblocks to such an amalgamation. Each current regulatory agency has its own constituency in the industries that have developed competitive positions based on regulatory restrictions.[442] The regulatory agencies themselves will fight fiercely to protect their territory, as demonstrated by the CFTC and SEC conflicts. Congressional committees also have their own jurisdictions to guard. Nevertheless, the functional system of regulation now existing in America needs to be abandoned. In its place, regulatory attention needs to be directed as to who needs regulation and who does not.[443]

For example, regulatory protections of the insurance fund should be uniform and limited. The current excuse for intrusive regulation as being necessary to protect the insurance fund should also be reexamined. Brokerage firms already obtain insurance from the private sector in excess of that provided by SIPC without such intrusive regulation.[444] The concern with systemic risk from large failures of financial institutions could be addressed across sector lines. Value At Risk programs could replace the labyrinth adopted by the SEC and CFTC in their net capital programs. With respect to fraud, the SEC and CFTC already recognize that sophisticated "accredited" investors do not need the same regulatory protections as the proverbial widows and orphans.[445] This approach should be applied to

442. There have been efforts to combine regulatory responsibilities. For example, the Chicago Mercantile Exchange ("CME") has unsuccessfully proposed the creation of a single department for financial services regulation. CHICAGO MERCANTILE EXCHANGE, FINANCIAL REGULATION FOR THE 21ST CENTURY (1995). The CME proposal was not a particularly radical one, since it would have continued functional regulation in bureaus within the department. *Id.*

443. This proposal is discussed at greater length in Broome & Markham, *supra* note 19, at 776–84.

444. *See* Markham, *Banking Regulation: Its History and Future, supra* note 4, at 284 (discussing private insurance alternatives).

445. "It was understood, even before the enactment of the Securities Act of 1933, that institutional investors did not need the mandatory disclosure system of that Act to protect themselves when acquiring securities. These investors could 'fend for themselves.'" Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 659 (1995). *See also, e.g.*, Regulations and

all financial services. Regulation should be directed at protecting small investors from overreaching and fraud.[446] Accredited investors can take care of themselves in addressing those risks.[447]

Terms Used in Regulation D, 17 C.F.R. § 230.501 (2002) (exempting securities from registration that are sold to accredited investors); CFTC Regulation 17 C.F.R § 4.7 (exempting institutions and wealthy individuals from certain disclosure requirements). The Commodity Futures Modernization Act of 2000 ("CFMA"), Pub. L. No. 106-554, 114 Stat. 2763, is another example where regulatory distinctions are made between large and small firms. Access to derivative transaction facilities ("DTFs") is limited to large institutions, except that a DTF may allow non-institutional access if introduced through an intermediary registered with the CFTC as a futures commission merchant. Such FCMs must, however, have minimum net capital of at least $20 million, assuring a responsible intermediary. 7 U.S.C. § 7a(b)(3)(B)(iv) (2000), *amended by* The Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A.

446. Most violations by broker-dealers, and certainly the most egregious, are committed by small under-capitalized firms that have little to lose if caught and much to gain by fraud and other misconduct. Yet, the SEC makes little distinction between large and small brokerage firms. The large firms must, therefore, bear the costs imposed by the fly-by-night firms. Large firms do not need such intensive regulation. They have an incentive to protect their assets from short-term profits generated by fraud that impose larger long-term costs in damages and reputational loss. Further, they have assets that are available to compensate those injured by employees who go astray.

The federal banking laws contain a limited recognition of the disparity of regulatory problems emanating from smaller, less capitalized institutions. Prior to 1991, all banks paid a uniform 12 cents per $100 of deposits as premiums for deposit insurance. The Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified as amended in scattered sections of 12 U.S.C.), changed that methodology by instituting a system of risk-based deposit insurance premiums that imposed greater costs on institutions that provided the greatest threats to the deposit fund. Banking regulations also utilize the concept of "well capitalized" to allow larger banks to engage in activities that less capitalized institutions would be inclined to engage in without adequate controls. BROOME & MARKHAM, *supra* note 11, at 465 (also noting that the reserve fund for the FDIC is now fully funded for the required reserves and deposit premiums are not presently being collected). For example, banks are also restricted in accepting brokered deposits unless they are well capitalized. 12 U.S.C. § 1831f(a) (2000). The GLBA requires that a bank holding company be well capitalized to be certified as a financial holding company that may engage in a broad range of financial activities outside customary banking channels. 12 U.S.C. § 1843(l)(1) (2000).

447. An official of the Federal Reserve Board has argued that even unsophisticated consumers should be able to buy unregulated products. Indeed, consumers already have a choice of depositing their funds either in an unin-

In sum, a more modern regulatory model should also be based on the following principles:

> (1) Institutions dealing with other institutions should not be subject to intrusive regulation. Institutions are able to watch out for themselves and do not need a government agency to protect them from other members of their industry.
>
> (2) Markets in which only institutions operate should not be regulated. Once again, institutions are able to protect themselves and have the bargaining power to demand information needed for trading.
>
> (3) Unregulated markets should be allowed to operate in which non-institutional customers may gain access through well capitalized intermediaries. Those intermediaries have assets and reputations to protect, which should be sufficient incentive for them to avoid fraud.
>
> (4) Retail customers should be allowed to deal with unregulated intermediaries even in regulated markets, provided that the intermediary is well capitalized and the customer is fully informed of the lack of regulation.
>
> (5) Markets should be allowed to operate, in which intermediaries that are not well capitalized service retail customer orders. But such markets, and those intermediaries that are not well capitalized, will be subject to regulation to assure their financial soundness.

IX. CONCLUSION

The issue of the desirability of a single super regulator over securities and derivatives has been debated since the creation of the CFTC in 1975. There has been little success in achieving any unified regulation. Still, the issue will not recede, and a unified regulator seems to be a sound idea. The model provided by the FSA-UK lends support for such unification, while the model presented by the FSA-Japan shows the weaknesses of such an approach. Should America choose a super regulator, it must be cautious to avoid an agency that will seek to manage the economy or respond to every financial crisis with more in-

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sured money market account or in an insured bank account. Oliver I. Ireland, Fed. Associate General Counsel, New Regulatory Models Institutional vs Functional Regulation, Paper presented at the Annual Chicago-Kent Conference on Derivatives Transactions (Oct. 1999) (on file with author).

trusive regulation. Until then, we must suffer under a competitive system of regulation that is competing for more — and not less — regulation.