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THE FUTURE OF THE SECURITIES AND EXCHANGE COMMISSION AS A MARKET REGULATOR

Roberta S. Karmel*

I. INTRODUCTION

Until 1975, the Securities and Exchange Commission (SEC) functioned as a market regulator, but its responsibilities were limited. Pursuant to the Securities Act of 1933 (Securities Act)¹, the SEC regulated public offerings of securities. Pursuant to the Securities Exchange Act of 1934 (Exchange Act),² the SEC had a mandate to maintain fair and orderly secondary markets in securities, and did so by enforcing anti-manipulation provisions of the Exchange Act, disciplining broker-dealers and their associated personnel and overseeing the national securities exchanges and the National Association of Securities Dealers (NASD). Initially, the NASD was an association of over-the-counter (OTC) broker-dealers, but it later became a self-regulatory organization (SRO) for all broker-dealers.³ Promulgating short selling rules was one of the SEC's original mandates, and the SEC did so through the "uptick" rule with regard to listed securities.⁴ The SEC also had responsibility for enforcing the net capital rule, but the New York Stock Exchange (NYSE) was primarily responsible for enforcing this rule against NYSE member firms.⁵ The Exchange Act also addressed the regulation of securities credit. While the Federal Reserve Board promulgated these regulations, the SEC enforced them against broker-dealers, but not against banks or nonbank,

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1. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77mm (2006)).

2. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78oo (2006)).

3. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J. L. BUS. & FIN. 151 (2008).

4. See generally David C. Worley, *The Regulation of Short Sales: The Long and Short of It*, 55 BROOK. L. REV. 1255, 1255 (1990).

5. The SEC permitted broker-dealers to comply with the net capital rules of their SRO if the SRO's rule was more stringent than the SEC's rule. Francis J. Facciolo, *Father Knows Best: Revised Article 8 and the Individual Investor*, 27 FLA. ST. U. L. REV. 615, 676 (2000).

noninvestment bank lenders.⁶

The Commodities Futures Trading Commission (CFTC) did not exist until 1974, when the Commodity Futures Trading Commission Act⁷ was passed. Before then, the Department of Agriculture regulated commodities futures and commodities exchanges, and that Department did not transfer authority to the CFTC until 1975.⁸ That same year, the 1975 Act Amendments to the Exchange Act⁹ gave the SEC the responsibility to facilitate the creation of a national market system for securities trading. Since many of the same firms that traded securities also traded commodities, and the CFTC was patterned to some extent upon the SEC, Congress could have given the SEC responsibility for monitoring futures trading and futures exchanges. However, when the White House offered Ray Garrett, Chair of the SEC and a corporate finance lawyer, regulatory jurisdiction over the futures markets, he declined this opportunity.¹⁰ His response was probably unfortunate, since in 1975, the CFTC approved the first futures contracts on securities, including the Chicago Board of Trade's (CBOT) futures contract on Government National Mortgage Association certificates (Ginnie Mae's), and the Chicago Mercantile Exchange's (CME) futures contract on ninety-day Treasury Bills.¹¹ Although the CFTC was given exclusive jurisdiction over exchange-traded futures contracts, the explosive growth of derivatives in the years after 1975 set off a jurisdictional battle between the SEC and the CFTC over the regulation of financial futures. Creation of the Chicago Board Options Exchange (CBOE) in 1973 exacerbated the dispute about whether financial futures were commodities or securities, because options on securities came to be regulated by the SEC in a different manner than the regulation of futures on securities, by the CFTC.¹²

6. See 15 U.S.C. 78g(a) (2006). Also, SROs had their own margin rules, which were more stringent than federal margin requirements.

7. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (amending 7 U.S.C. §§ 2, 4 (2006)).

8. THE DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 45 n.8 (2008), available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf> [hereinafter BLUEPRINT].

9. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15 U.S.C.) (amending the Exchange Act).

10. John D. Benson, Comment, *Ending the Turf Wars: Support for a CFTC/SEC Consolidation*, 36 VILL. L. REV. 1175, 1175 (1991) (citing Schneider & Schapiro, *What Corporate Lawyers Should Know About Commodity Futures Law*, in 21ST ANNUAL INSTITUTE ON SECURITIES REGULATION 71 (1990)).

11. BLUEPRINT, *supra* note 8, at 46.

12. See Jerry W. Markham & David J. Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741, 786-90 (1983).

In the midst of Wall Street's financial meltdown in 2008 and the ensuing change of Administrations in Washington, the head of the SEC,¹³ former SEC chairs¹⁴ and the trade association for the securities industry (SIFMA)¹⁵ were on record recommending a merger of the SEC and the CFTC. The Acting Head of the CFTC demurred, calling for three regulators to focus on risk, market integrity, and investor protection, into which both the SEC and the CFTC would be folded.¹⁶ A "three peaks" consolidation of all federal financial regulators also has been urged by securities industry trade associations.¹⁷ The Treasury Blueprint for financial regulatory reform, published earlier in 2008, also advocated consolidating the regulators for securities and derivatives markets.¹⁸ In addition, the Blueprint recommended that the SEC adopt "core principles" for exchanges and clearing agencies, as well as an expedited approval process for rules of self-regulatory organizations (SROs).¹⁹ This mode of regulation was patterned after the mandate given to the CFTC in the Commodity Futures Modernization Act of 2000 (CFMA), to engage in principles-based, rather than rule-based regulation.²⁰ Since the United States is the only country where regulation of securities and financial futures is conducted by different regulatory agencies,²¹ whether to combine the SEC and the CFTC has been discussed for many years. The debates on this topic have been by

13. Karey Wutkowski, *SEC's Cox says supports merger of agency. CFTC*, REUTERS, Oct. 24, 2008, <http://www.reuters.com/article/ousiv/idUSTRE49N0MY20081024>.

14. Arthur Levitt, *How to Restore Confidence in Our Markets*, WALL ST. J., Oct. 22, 2008, at A15; *Turmoil in the U.S. Credit Markets: Examining the Regulation of Investment Banks by the U.S. Securities and Exchange Commission: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 110th Cong. 9–10 (2008) (testimony of David S. Ruder, Former Chairman, SEC), available at http://banking.senate.gov/public/_files/RuderSenateTestimonyMay72008.pdf.

15. *The Future of Financial Services Regulation: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 7 (2008) (testimony of T. Timothy Ryan, Jr., President and CEO, Sec. Indus. & Fin. Mkts. Ass'n), available at http://financialservices.house.gov/hearing110/t_ryan102108.pdf.

16. Kara Scannell, *CFTC's Chief: 3 Regulators for 2*, WALL ST. J., Nov. 12, 2008, at C3.

17. See, e.g., Comm. on Capital Mkts. Regulation, Recommendations for Reorganizing U.S. Regulatory Structure 4 (Jan. 14, 2009), <http://www.capmksreg.org/pdfs/CCMR%20-%20Recommendations%20for%20Reorganizing%20the%20US%20Regulatory%20Structure.pdf>; INV. CO. INST., FINANCIAL SERVICES REGULATORY REFORM: DISCUSSIONS AND RECOMMENDATIONS 5 (2009); *Enhancing Investor Protection and the Regulation of Securities Markets: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. (2009) (testimony of T. Timothy Ryan, Jr., President and CEO, Sec. Indus. & Fin. Mkts. Ass'n), available at <http://www.sifma.org/legislative/testimony/pdf/Ryan-03-10-2009.pdf>.

18. BLUEPRINT, *supra* note 8, at 137–38.

19. *Id.* at 106.

20. Pub. L. No. 106-554, app. E, 114 Stat. 2763 (codified as amended in scattered sections of 7, 11, 12, & 15 U.S.C.).

21. Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 YALE J. ON REG. 279, 282 (1997).

academics,²² and policy makers,²³ but the financial crisis has highlighted some of the problems of the U.S. system of functional regulation, with its proliferation of financial regulators.

The predicates for the Treasury Blueprint recommendations were product convergence, inefficiencies of a functional approach to regulation, and globalization of the capital markets.²⁴ Prior governmental recommendations for either a merger of the SEC and the CFTC, or at least better coordination between them, were predicated on the need for better surveillance and enforcement of intermarket trading, and a need to monitor systemic risk and reduce volatility in the capital markets.²⁵ A sitting SEC Commissioner has advocated merging the SEC and the CFTC, and the current SEC Chair, Mary Schapiro, advocated merger many years ago when she was an SEC commissioner.²⁶ Schapiro is more equivocal about a merger now.²⁷ Significantly, neither the SEC nor the CFTC had meaningful jurisdiction to halt or limit trading in the financial products that led to the current financial crisis.

The Blueprint was a highly political document issued in the last year of the Bush Administration—at the nadir of government pressures for deregulation—by a Secretary of the Treasury who was the former head of Goldman Sachs & Co. The Blueprint contains a not very subtle criticism of the way the SEC, pursuant to its statutory obligations to regulate exchanges and markets, has administered relevant provisions of the Exchange Act. While the Obama Administration has not adopted the

22. See, e.g., *id.*; Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and For Corporate Law*, 70 N.C. L. REV. 137, 176 (1991).

23. See Christopher L. Culp, *Stock Index Futures and Financial Market Reform: Regulatory Failure or Regulatory Imperialism?*, 13 GEO. MASON U. L. REV. 517, 517–18 (1991); Stephen J. Friedman & Connie M. Friesen, *A New Paradigm For Financial Regulation: Getting from Here to There*, 43 MD. L. REV. 413, 448 (1984); Thomas A. Russo & Marlisa Vinciguerra, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431, 1495–1500 (1991).

24. BLUEPRINT, *supra* note 8, at 106–09.

25. See H.R. 718, *Markets and Trading Reorganization and Reform Act of 1995: Hearings Before the H. Subcomm. On Capital Mkts., Sec., and GSEs of the Comm. on Banking & Fin. Servs.*, 104th Cong. 224 (1995) (prepared statement of James L. Bothwell, Director, Fin. Insts. & Mkts. Issues, Gen. Gov't. Div., U.S. Gen. Accounting Office).

26. Jesse Westbrook, *SEC Should Police Swaps, Merge with CFTC, Walter Says*, BLOOMBERG, Mar. 2, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=ajEyt7d_5xoY&refer=us; Kevin G. Salwen, *Nominee for SEC Supports CFTC on Index Futures*, WALL ST. J., Sept. 24, 1990, at A7A.

27. See Richard Hill, *Schapiro Tells House Panel SEC To Weigh Wide-Ranging Reform Proposals*, 41 Sec. Reg. & L. Rep. (BNA) 446 (Mar. 16, 2009). But she may be more capable of effecting such a merger than past chairs. See Floyd Norris, *Can Mary Schapiro Save the S.E.C.?*, N.Y. TIMES, Dec. 17, 2008, <http://norris.blogs.nytimes.com/2008/12/17/can-she-save-the-sec/>.

deregulatory philosophy of the Blueprint, it continues to be discussed as a viable framework for financial regulatory reform. Moreover, the Obama Administration's recommendations for financial regulatory reform (Treasury White Paper) do not break much new ground, and do not recommend consolidating the SEC and the CFTC.²⁸ Policymakers should, nevertheless, seriously consider merging the SEC and the CFTC.

A new systemic risk regulator for financial institutions is also under consideration and may take some market regulation responsibilities away from the SEC. Other proposals, such as the creation of a new business conduct regulator for financial institutions and markets, or a financial consumer products protection agency, could result in the transfer of some of the SEC's market regulation functions to another agency.²⁹ Making the Federal Reserve Board a more powerful financial stability regulator, as recommended by the Blueprint and the Treasury White Paper,³⁰ has to some extent already occurred, but would not reduce market volatility or control the proliferation of questionable financial products unless the Federal Reserve Board becomes more committed to reducing leverage and speculation than it has for many years. Barney Frank, House Financial Services Committee Chair, at one time asserted that the SEC and the CFTC should be merged and that the Federal Reserve Board or a new systemic risk regulator should oversee the risks that led to the market meltdown in 2008.³¹ There remain, however, many different views on whether there should be limited or total merger of federal financial regulatory agencies, and what the role of the Federal Reserve Board should be.³² Further, as of the date of this Article, neither a merger of the SEC and the CFTC, nor any other meaningful consolidation of financial regulators appears likely.

Part II of this Article summarizes the jurisdictional conflicts between the SEC and the CFTC and explains how their regulatory philosophies

28. See THE DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter TREASURY WHITE PAPER].

29. Current versions of legislation to create a consumer financial protection agency do not take away the SEC's authority over any financial products or markets. See Consumer Financial Protection Agency Act of 2009, 111th Cong. (as reported by the H. Comm. on Energy and Commerce, Dec. 9, 2009); see also Financial Stability Improvement Act of 2009, H.R. 3996, 111th Cong. (ordered to be reported by the H. Comm. on Fin. Servs., Dec. 2, 2009).

30. BLUEPRINT, *supra* note 8, at 146–48; TREASURY WHITE PAPER, *supra* note 28, at 22–24.

31. Kara Scannell, *Frank Backs Regulator for Systemic Risk*, WALL ST. J., Feb. 4, 2009, at C3. SIFMA also has backed a financial stability regulator separate from the SEC. See Testimony of T. Timothy Ryan, Jr., *supra* note 15, at 3–6.

32. See Malini Manickavasagam, *Senate Hearing Underscores Divisions Over Idea of Fed as Systemic Risk Regulator*, 41 Sec. Reg. & L. Rep. (BNA) 450 (Mar. 16, 2009).

regarding market regulation have diverged. I believe that in recent years, both agencies have been more interested in promoting new trading markets and the U.S. securities industry than in keeping existing markets fair and orderly.

Part III will discuss why the SEC and the CFTC have remained separate. It argues that the SEC and the CFTC have not been consolidated because of competitive and political factors in the securities industry, combined with Congressional politics. Although consolidating the SEC and the CFTC could solve some of the problems in the capital markets, as soon as regulatory reform was discussed in response to the financial crisis, the congressional oversight committees for the SEC and the CFTC began playing politics and resisting consolidation of the agencies.³³ Further, the Obama Administration threw in the towel on this consolidation without a fight.³⁴ In any event, Congress should not merge these regulators unless it also revises, or instructs a combined SEC and CFTC to revise, the statutory frameworks for regulating securities and financial futures. The difficulties of such a project are demonstrated by the hearings on harmonization of SEC and CFTC regulation.³⁵ Part III also discusses the general opposition of successive Administrations to regulation that would dampen leverage and speculation or curtail the expansion of derivatives, even though the securities markets confronted serious problems in 1987 and 1995 caused by derivatives trading.

Part IV of this Article suggests several areas where SEC market regulation has failed and new areas where the SEC, or a combined SEC and CFTC, or some new regulator, should focus with respect to market regulation. These areas are broker-dealer capital adequacy, credit and other OTC derivatives trading, short sales, and regulation of hedge funds. Part V concludes with the hope for a better working relationship between financial regulators to create better regulation of the securities industry and markets.

The provisions of the Exchange Act dealing with regulation of the securities markets were passed in 1975 in order to unfix commission rates, integrate exchange and OTC markets, inject greater competition into the trading markets, and give the SEC authority to regulate clearing agencies, transfer agencies, and other market intermediaries. The SEC administered this statute in a heavy-handed manner, according to detailed rules, which may have been one of the many factors leading to

33. See Richard Hill, *Lawmakers' Attention Continues to be Focused on Speculation, OTC Clearing*, 41 Sec. Reg. & L. Rep. (BNA) 128 (Jan. 26, 2009).

34. See *Better broth, still too many cooks*, *ECONOMIST*, June 20, 2009, at 13.

35. See *infra* notes 70–71 and accompanying text.

the explosion of unregulated trading markets in both securities and derivatives. In 2000 Congress instructed the CFTC to regulate according to principles, rather than rules, and to leave the OTC derivatives market alone. The goal of financial innovation trumped the goal of financial stability. Both the SEC and CFTC, directly, and through their congressional oversight committees, have suffered from regulatory capture by the securities industry. The mandates and regulatory methodologies for these two agencies should be reconciled, and both should be made more workable and freer from industry and congressional interference. Although these agencies are “independent,” neither is sufficiently large, well-funded, or protected by powerful political forces—particularly after the financial crisis for which they are being blamed—to operate as the expert regulators they were intended to be. Further, the SEC needs new authority and greater funding to regulate important unregulated sectors of the securities markets, such as credit derivatives and hedge funds.³⁶ Regulation of other sectors, such as credit rating agencies (CRAs) and investment advisors, needs to be substantially strengthened. Furthermore, exemptions for so-called sophisticated investors have proven chimerical and need to be reexamined.³⁷ These regulatory areas, however, impact market regulation only indirectly, and are beyond the scope of this Article.

In healthy economic times, there has been a tension between Wall Street and Main Street—that is between finance and industry—which is a good check and balance in a capitalist system. Since the 1980s, regulators have permitted and even encouraged financial interests to overwhelm industry’s needs. Market or trading interests, rather than capital formation and investor protection, became the focus of financial regulators. While the genie unleashed by derivatives trading cannot be put back into a magic lamp, the leverage injected into the financial markets by derivatives needs to be seriously and permanently reduced, not merely constrained until the next financial bubble. A significant goal of the Exchange Act was reducing and controlling securities credit, but financial regulators forgot the importance of limiting such credit. Further, the SEC of the future, whatever its amended organization, statutory authority, and mandates, should refocus on capital formation in the stock and bond markets and protecting investors’ retirement savings.

36. See Joanna Chung, *Schumer seeks SEC funding reform*, FIN. TIMES, Sept. 4, 2009, at 4.

37. See Roberta S. Karmel, *Regulation By Exemption: The Changing Definition of an Accredited Investor*, 39 RUTGERS L. J. 681, 681–86 (2008).

II. JURISDICTIONAL AND PHILOSOPHICAL CONFLICTS BETWEEN THE SEC AND CFTC

A. Regulatory Histories

The separate regulatory histories and philosophies of the SEC and the CFTC have been detailed by others and are only summarized here.³⁸ The SEC is a full disclosure agency and has relied upon Section 10(b) and Rule 10b-5, as well as antimanipulative provisions of the Exchange Act, to police the markets, including insider trading practices.³⁹ The CFTC does not have comparable authority with regard to insider trading. While the SEC has relied on suitability requirements and insurance of cash and securities in broker-dealer customer accounts, the CFTC does not have similar regulations.⁴⁰ The margin rules for trading in securities and commodities are different.⁴¹ Until recently, the SEC had short selling rules to control market volatility, whereas the CFTC had price and position limits.⁴²

The CFTC has relied on policing exchange markets and a statute, which until 2000, forced virtually all commodities futures trading on to exchange markets to control fraud and manipulation. The SEC, by contrast, was charged by the 1975 amendments to the Exchange Act with integrating exchange and OTC markets, as well as injecting competition between markets into securities trading.⁴³ In the face of a recalcitrant industry, in order to accomplish these goals, the SEC engaged in detailed rulemaking.⁴⁴ Since the mid-1970s, the securities markets have undergone vast changes, and although the goals of the national market system are not irrelevant, competition between the SEC and the CFTC, a deregulatory mood in Washington, and competition with foreign markets (especially London), have weakened the SEC's authority. The NYSE has merged with Euronext⁴⁵ and does little floor trading, Nasdaq has become an entirely electronic national securities

38. See generally Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOK. J. INT'L L. 319, 341-56 (2003); Russo & Vinciguerra, *supra* note 23, at 1444-50.

39. Russo & Vinciguerra, *supra* note 23, at 1492-94.

40. Markham, *supra* note 38, at 344-45.

41. *Id.* at 369 n.257; Russo & Vinciguerra, *supra* note 23, at 1494-95.

42. NICHOLAS DEB. KATZENBACK, AN OVERVIEW OF PROGRAM TRADING AND ITS IMPACT ON CURRENT MARKET PRACTICES 14-18 (1987).

43. See 15 U.S.C. § 78k-1 (2006).

44. See generally Junius W. Peake, *Entropy and the National Market System*, 1 BROOK. J. CORP. FIN. & COM. L. 301 (2007).

45. NYSE Euronext Form 10-K, For the fiscal year ending Dec. 31, 2008, at ii.

exchange,⁴⁶ and the issue confronting regulators is whether trading in unregulated markets (dark pools) should be more transparent.⁴⁷ In short, what is needed is a new look at old problems, but it is questionable whether the Exchange Act's national market provisions give the SEC the mandate or the authority to deal with today's global trading markets.

Securities trading exists to assist capital formation. Commodities trading is designed to enhance price discovery and spread risk. The primary goal of the SEC is investor protection, while the CFTC oversees the hedging of risk, which necessarily encourages speculation.⁴⁸ Whether the mandates and regulatory philosophies of the SEC and the CFTC can be successfully melded is a difficult question. But by allowing the CFTC to regulate derivatives on securities as commodity futures, and exempting OTC derivatives from any regulation, Congress undermined the SEC's ability of to function effectively as a market regulator, particularly with regard to securities credit, short selling and broker-dealer capital adequacy regulation.

The Blueprint argued that the CFTC's regulatory philosophy was superior to the SEC's regulatory approach because the CFTC based its regulation on principles, whereas the SEC based its regulation on rules. Similar claims have been made about the principles-based approach of the Financial Services Authority in the United Kingdom as compared to the SEC's rules-based approach. But this dichotomy between principles and rules is not supportable by the way in which regulators conduct themselves.⁴⁹ Although the SEC's net capital rules, margin rules, and short sale rules are rules, they are supplemented by broad principles of general applicability.⁵⁰ Further, the SEC's antifraud and antimarket manipulation rules are principles-based, but may "morph into multi-factor tests," which function as rules, where rulemaking is delegated to SROs.⁵¹ In criticizing the SEC for rule-based regulation, the Blueprint

46. In the matter of the Application of the Nasdaq Stock Market LLC for Registration as a National Securities Exchange, Exchange Act Release No. 53128, 71 Fed. Reg. 3550 (Jan. 23, 2006).

47. See generally Roger D. Blanc, *Intermarket Competition and Monopoly Power in the U.S. Stock Markets*, 1 BROOK. J. CORP. FIN. & COM. L. 273 (2007). See also Jeremy Grant, *Exchanges body issues 'dark pools' warning*, FIN. TIMES, Sept. 23, 2009, at 6; Scott Patterson, Kara Scannell & Geoffrey Rogow, *Ban on Flash Orders Is Considered by SEC*, WALL ST. J., Aug. 5, 2009, at C1, C3.

48. Although there can be hedgers on both sides of a commodities futures contract, generally one side is a hedger and the other side is a speculator. This is not inherently bad because it aids price discovery for agricultural commodities. But in the financial futures arena, it inevitably leads to speculation, which can become destructive.

49. See generally Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411, 1492 (2007).

50. *Id.* at 1447-49.

51. *Id.* at 1451.

and others may be asking for approaches more sympathetic to the industry.⁵² According to the North American Securities Administrators Association (NASAA), a principles-based approach to regulation is not a substitute for “clear and . . . prescriptive rules. Broadly framed standards of conduct can serve as helpful guides for industry as well as useful enforcement tools for regulators, but standing alone, they leave too much room for abuse.”⁵³

B. Jurisdictional Conflicts

The SEC objected when the CFTC approved Ginnie Mae futures, and then in 1978, unsuccessfully requested that Congress give it jurisdiction over all derivative products relating to underlying instruments that were securities.⁵⁴ Six years after the CBOT began trading in Ginnie Mae futures, the SEC approved trading in Ginnie Mae options by the CBOE. The CBOT successfully sued the SEC, claiming that the CFTC had exclusive jurisdiction over these options because they were futures contracts rather than securities.⁵⁵ To alleviate the rivalry between the two agencies, CFTC Chair Phillip Johnson and SEC Chair John Shad negotiated an accord in 1982 purporting to settle the jurisdictional differences between the agencies.⁵⁶ This agreement provided that the CFTC was to have exclusive jurisdiction over all futures contracts, options on futures, stock index futures and options on stock index futures, while the SEC was to have jurisdiction over options on securities and options on stock indexes. Subsequently, Congress gave a statutory imprimatur to this accord.⁵⁷

A myriad of studies conducted after the 1987 stock market crash concluded that futures and securities had become one market, and prices during the market downdraft in October 1987 were set by the futures

52. The CFTC is run by economists, rather than lawyers, who tend to defer to the exchanges. Markham, *supra* note 38, at 360.

53. Press Release, North American Securities Administrators Association, NASAA Outlines Core Principles for Regulatory Reform in Financial Services (Nov. 19, 2008), available at http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/9781.cfm#.

54. John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 461 (1995).

55. Board of Trade v. S.E.C., 677 F.2d 1137, 1155–59 (7th Cir. 1982), *vacated*, 459 U.S. 1026 (1982).

56. SEC and CFTC, Joint Explanatory Statement, [1980-82 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,332 (Feb. 2, 1982); see William J. Brodsky, *New Legislation Permitting Stock Futures: The Long and Winding Road*, 21 NW. J. INT'L L. & BUS. 573, 574–75 (2001).

57. Act of Jan. 11, 1983, Pub. L. No. 97-444, 96 Stat. 2294 (codified as amended in scattered sections of 7 & 15 U.S.C.); Act of Oct. 13, 1982, Pub. L. No. 97-303, 96 Stat. 1409 (codified as amended in scattered sections of 15 U.S.C.).

markets.⁵⁸ The SEC charged that futures trading had disrupted the setting of prices by stock exchanges, thereby threatening their future, and asked Congress to transfer jurisdiction over futures on stock indexes from the CFTC to the SEC.⁵⁹ Not only did the SEC lose this battle, but in 1989, it lost another case in the Seventh Circuit in which the Chicago Mercantile Exchange (CME) and CBOT challenged the SEC's approval of index participations by the Philadelphia and American stock exchanges.⁶⁰

At this point, the SEC aggressively fought to merge the SEC and the CFTC, but the CFTC defended its existence.⁶¹ A replay of this turf war occurred in the early 1990s when the CME proposed that the CFTC and the SEC be consolidated into a super-regulator with various banking agencies.⁶² In all of the jurisdictional battles between the SEC and the CFTC, the Federal Reserve Board was an active player, garnering power to itself, and, just as the SEC and CFTC were protecting their regulated industries, the Federal Reserve Board was looking out for the interests of the banks over which it had authority.⁶³ This three-way rivalry came to a head in the CFMA,⁶⁴ which permitted commodities exchanges to trade single stock futures. Further, to the extent that the SEC and CFTC disagreed upon the margin requirements for a single stock future, the Federal Reserve Board was designated as a mediator and arbitrator.⁶⁵ Unfortunately, the CFMA legislated that the trading of OTC financial derivatives between sophisticated counterparties should be excluded from regulation by the CFTC, the SEC or anyone else.⁶⁶ The CFMA justified this on the ground that most OTC financial derivatives were not susceptible to manipulation. Accordingly, the CFMA excluded the OTC derivatives markets from commodities regulation, including the antifraud provisions.⁶⁷ Because by definition these instruments were commodities futures contracts, they were not regulated as securities either.

58. See Roberta S. Karmel, *The Rashomon Effect in After-the-Crash Studies*, 12 REV. OF SEC. & COMMODITIES REG. 101, 103-04 (1988).

59. Coffee, *supra* note 54, at 462.

60. *Chi. Mercantile Exch. v. S.E.C.*, 883 F.2d 537, 548-50 (7th Cir. 1989).

61. See John D. Benson, *Ending the Turf Wars: Support for a CFTC/SEC Consolidation*, 36 VILL. L. REV. 1175, 1189 (1991).

62. See Coffee, *supra* note 54, at 449.

63. *Id.* at 460.

64. Pub. L. No. 106-554, app. E, 114 Stat. 2763 (codified as amended in scattered sections of 7, 11, 12, & 15 U.S.C.).

65. See 15 U.S.C. § 78g(c)(2)(B) (2006).

66. See *id.* §§ 78c(a)(11), (55), (56).

67. BLUEPRINT, *supra* note 8, at 47.

In the past, the CFTC resisted consolidation with the SEC because it believed it would be submerged into a larger, more respected agency.⁶⁸ Currently, it is the SEC that may fear consolidation, in view of the criticisms leveled at the agency in the Blueprint as being too stringent in its regulatory rulemaking compared to the CFTC, and later, criticisms by congressmen and other critics, as being too lax in its regulatory and enforcement programs during the Bush Administration.⁶⁹ However blameworthy the SEC may be, much more blame for the financial meltdown belongs to the Federal Reserve Board for embracing derivatives, and to Congress, which was too responsive to special interests and campaign contributions from Wall Street and La Salle Street, and indifferent to the interests of Main Street and public investors.

The Obama Administration has tasked the SEC and the CFTC with recommending statutory and regulatory changes to Congress that would harmonize the regulation of futures and securities. As a first effort, the agencies are to identify to Congress “all existing conflicts in statutes and regulations with respect to similar types of financial instruments and either explain[] why those differences are essential to achieve underlying policy objectives with respect to investor protection, market integrity, and price transparency or make[] recommendations . . . that would eliminate the differences.”⁷⁰ To that end, the two agencies held joint hearings in September 2009 to assess their current regulatory schemes, with a view to harmonization. The hearings covered a daunting array of issues, including several which involve market regulation directly, including clearance and settlement, margin requirements, and enforcement policies. It is unlikely that the SEC and the CFTC will be able to harmonize their regulations in these areas.

In the report of the SEC and the CFTC on harmonization, issued after these hearings, the two agencies recommended that legislation should provide a process for expedited judicial review of judicial matters regarding new products.⁷¹ They stated they would support legislation that allowed the CFTC to exercise jurisdiction over an instrument that the SEC exempts and clarified that the SEC could exercise authority

68. See Coffee, *supra* note 54, at 451.

69. Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 27, 2008, at A1; Michael Cooper, *McCain Says S.E.C. Chairman Should Be Fired*, N.Y. TIMES, Sept. 18, 2008, <http://thecaucus.blogs.nytimes.com/2008/09/18/mccain-says-sec-chairman-should-be-fired/?dbk>; John C. Coffee, Jr., *The Lessons of Madoff*, NAT'L L.J., Mar. 16, 2009, at 12.

70. TREASURY WHITE PAPER, *supra* note 28, at 50–51; See also Joint Meetings on Harmonization of Regulation, Exchange Act Release No. 60539, 2009 WL 2595551 (Aug. 19, 1009).

71. CFTC and SEC, A Joint Report of the SEC and the CFTC on Harmonization of Regulation 87 (Oct. 16, 2009) ([hereinafter Joint Report]).

over a securities-related products that the CFTC has exempted. Further, there should be a time line for the two agencies either to use their exemptive authority or to come to an agreement on the status of any new product.⁷² The Joint Report by the SEC and the CFTC demonstrates important conflicts between their statutory mandates. Although the report contains many helpful ideas for bridging those gaps, such as the creation of joint advisory committees to develop solutions to emerging and ongoing issues, a joint agency enforcement task force, a cross agency training program, and a joint information technology task force,⁷³ the Joint Report also demonstrates the difficulty of reconciling their statutory mandates. In areas such as margin requirements, clearing, and the prohibition of manipulation, insider trading, and fraud, the agencies have very different approaches. Further, the failure of the Administration to recommend merger of these agencies is a lost opportunity for sensible and necessary regulatory reform.

The Administration's proposed Over-the Counter Derivatives Markets Act of 2009,⁷⁴ however, which would govern the swaps market, would harmonize some regulations and implement mechanisms for the Department of the Treasury to settle certain disputes between the SEC and the CFTC.

III. POLITICAL FORCES KEEPING THE SEC AND CFTC SEPARATE AND ENCOURAGING DERIVATIVES TRADING

When the political winds in Washington favored deregulation, some academics advocated competition between regulatory agencies as a method for reaching an appropriate regulatory result. Analogies were made to market competition as the route to optimum regulation and an avenue for encouraging creativity in the financial markets.⁷⁵ Others, including me, were not convinced that encouraging competition among regulators was a good idea, arguing that it leads to a race to the bottom, and that it is unseemly when government agencies fight one another in

72. *Id.* at 88.

73. *Id.* at 93–94.

74. U.S. Dep't of the Treasury, Over-the-Counter Derivative Markets Act of 2009, <http://www.financialstability.gov/docs/regulatoryreform/titleVII.pdf> (last visited Sept. 23, 2009) [hereinafter Over-the-Counter Derivative Markets Act], H.R. 3795, 111th Cong. (2009).

75. Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 916–18 (1988); John C. Coffee, Jr., *Racing Toward the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757, 1811–17 (2002); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2392–95 (1998).

court, directly or by proxy.⁷⁶ Regulatory competition, as seen in the battles between the SEC and the CFTC, has proven extremely unproductive and resulted in widespread use of unregulated OTC derivatives by financial institutions—a key cause of the current financial meltdown.

Why has this rivalry between two similar agencies persisted for so long, and who has benefited? The simple answer is that congressmen seeking campaign finance funds from the securities and commodities industries have benefited from the constant warfare between these agencies, along with the periodic fights over CFTC reauthorization.⁷⁷ The House and Senate agriculture committee members who had oversight over the commodities industry received huge campaign contributions from that sector, and of course, were reluctant to relinquish their power to other committees.⁷⁸ Similarly, members of the House and Senate banking and securities oversight committees enjoyed donations from Wall Street.⁷⁹ There was a geographical, as well as a power politics dimension to these battles. The commodity futures industry is based in Chicago; the securities industry in New York. The Seventh Circuit in Chicago played a role in helping the CBOT and CME win battles against the SEC. Large, agricultural interest groups repeatedly trumped financial interest groups, just as they have trumped urban interests in other political battles.⁸⁰ Although the securities and

76. See Roberta S. Karmel, *The Working Group Report*, N.Y. L.J., June 16, 1988, at 3; Frank Partnoy, *Multinational Competition and Single-Stock Futures*, 21 NW. J. INT'L L. & BUS. 641, 644–45 (2001); Robert A. Prentice, *Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred*, 66 OHIO ST. L.J. 1155, 1177–79 (2005).

77. The CFTC was (until 2000) subject to reauthorization by Congress every two years. See Mark Frederick Hoffman, Note, *Decreasing the Costs of Jurisdictional Gridlock: Merger of the Securities and Exchange Commission and the Commodities Futures Trading Commission*, 28 U. MICH. J.L. REFORM 681, 687 (1995). These reauthorization proceedings were costly and time consuming and made the CFTC vulnerable to political pressure and capture. *Id.* at 708; Jerry W. Markham, *The Commodity Exchange Monopoly—Reform Is Needed*, 48 WASH. & LEE L. REV. 977, 1004–12 (1991); Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 YALE J. ON REG. 279, 353–61, 363–68 (1997).

78. See Thomas Lee Hazen, *Rational Investments, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effect on the Underlying Capital Markets*, 86 NW. U. L. REV. 987, 1021–22 (1992). At the time of the 1987 stock market crash, the CME had one of the three or four biggest political action committees in the country. MARTIN MAYER, *MARKETS: WHO PLAYS, WHO RISKS, WHO LOSES* 129 (1988).

79. See Eric Lipton & Raymond Hernandez, *A Champion of Wall Street Reaps the Benefits*, N.Y. TIMES, Dec. 14, 2008, at A1; *SIA Leads in Handing Money Over to Congress*, WALL ST. LETTER, Aug. 22, 1988, at 2.

80. On March 27, 1990, eighteen agricultural associations jointly sent a letter to Senator Leahy, Chairman of the Senate Agriculture, Nutrition, and Forestry Committee, stating they believed it was necessary to maintain an independent CFTC because a merged agency would be overshadowed by securities interests. At this time, Wendy Gramm was Chair of the CFTC, and in a Senate hearing stated

commodities industries encouraged rivalry between the SEC and the CFTC, it is ironic that many of the players in those industries were part of the same financial conglomerates. But bifurcated regulation of the trading markets was necessarily weaker regulation, especially when the financial industry could claim that there was also regulatory competition with foreign regulators.

A more complicated answer to the continued fractious fighting between the SEC and the CFTC would include Alan Greenspan as a culprit because he was a consistent cheerleader for financial derivatives; he did not believe in curbing securities credit, and did not see it in the interest of the Federal Reserve Board to resolve the controversies between the SEC and CFTC by creating a more powerful combined market regulator. The Obama Treasury Department similarly has preferred to aggrandize its own power over a merged SEC and CFTC.⁸¹

When the federal securities laws were passed in the 1930s, Congress seriously considered how unregulated securities credit had fueled the 1920s bull market and led to the 1929 crash. The federal margin rules were promulgated to prevent any such future debacles, but the margin rules have long been ignored. A fundamental premise of the federal securities laws was that the stock market and securities industry intermediaries need to be regulated to protect the national banking system and the Federal Reserve System.⁸² In 1934, Congress was concerned about stock market speculation caused by undue securities credit,⁸³ believing that trading securities on credit could lead to significant problems in the national economy and the financial markets because credit-financed securities speculation diverted resources from more productive uses in commerce, industry, and agriculture.⁸⁴ Such activities created or reinforced stock market bubbles, and led many people “perhaps drawn in by the exuberance of the market” to assume

the SEC would be a “hostile regulator” over stock index futures. Because Wendy Gramm was the wife of Phil Gramm, the Chair of the Senate Banking Committee with oversight over the SEC, her words had a certain (questionable) weight. See Hazen, *supra* note 78, at 1022 n.195.

81. Under Section 711 of the proposed Over-the-Counter Derivatives Market Act of 2009, if the CFTC and the SEC cannot agree on a rule required under the law, the Department of the Treasury is given the authority to make rules and impose them on both agencies. Over-the-Counter Derivatives Markets Act of 2009, H.R. 3795, 111th Cong. § 111 (2009) (ordered to be reported by the H. Comm. on Fin. Servs.).

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

83. See H.R. REP. NO. 73-1383, at 4-6 (1984) (asserting that uncontrolled trading of securities on credit was a major cause of the Stock Market Crash of 1929); see also Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 728-33 (1999) (detailing the legislative history of the Securities Exchange Act).

84. BD. OF GOVERNORS OF THE FED. RESERVE SYS., A REVIEW AND EVALUATION OF FEDERAL MARGIN REGULATIONS 3 (1984) [hereinafter MARGIN STUDY].

securities positions of undue risk.⁸⁵

Among the tools Congress gave the SEC to deal with speculation were provisions regarding margin lending. The margin requirements, set forth in Section 7 of the Exchange Act, were designed to prevent the “excessive use of credit for the purchase or carrying of securities.”⁸⁶ The Federal Reserve Board was given responsibility to prescribe regulations with respect to the amount of securities credit that could be extended and maintained by financial institutions, in an amount not greater than either 55% of the current market price of the security or 100% of the lowest market price during the preceding 36 calendar months, but not more than 75% of the current market price.⁸⁷ The SEC was then given the responsibility for enforcing the margin regulations against broker-dealers.

Between 1936 and 1974, the Federal Reserve Board changed margin ratios twenty-five times, with levels ranging from a low of 40% in the late 1930s to a high of 100% just after World War II, but generally kept ratios between 50 and 70%.⁸⁸ In 1974, the Federal Reserve Board set margin rates at 50% and has not changed them since.⁸⁹ During and after the bull market of the late 1960s when margin rates were high, the margin regulations were taken so seriously that the SEC sanctioned broker-dealers that violated the margin rules,⁹⁰ and the Department of Justice criminally prosecuted banks and others for violations.⁹¹ Further, margin violations were actionable in private lawsuits.⁹² In 1984, however, the Federal Reserve Board recommended that margin regulation be abolished for two reasons. First, the primary purpose of such regulation should be to ensure the integrity of the marketplace by seeing that there is protection against significant credit loss for brokers, banks, and other lenders. Second, stock-based futures and options

85. *Id.*

86. 15 U.S.C. § 78g(a) (2006).

87. *Id.* Regulation T, applicable to broker-dealers, is 12 C.F.R. § 220.12 (2009).

88. MARGIN STUDY, *supra* note 84, at 48; *see* Broker-Dealer Operations Under Securities and Commodities Law (CBC) § 8:3 n.5 (2009).

89. Henry T. C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777, 798 (2000).

90. *See, e.g.*, *Sutro Bros. & Co.*, 41 S.E.C. 443, 1, 11–15 (1963).

91. *See, e.g.*, *United States v. Weisscredit Banca Commerciale E dD'Investimenti*, 325 F. Supp. 1384, 1387–89 (S.D.N.Y. 1971); *United States v. Whorl*, SEC Litigation Release No. 4478 (Nov. 24, 1969).

92. *See, e.g.*, *Junger v. Hertz, Neumark & Warner*, 426 F.2d 805, 806–07 (2d Cir. 1970); *Newman v. Pershing & Co.*, 412 F. Supp. 463, 466–65 (S.D.N.Y. 1975); *Remar v. Clayton Sec. Corp.*, 81 F. Supp. 1014, 1015–17 (D. Mass. 1949). This principle was later abandoned. *See Bennett v. U.S. Trust Co. of N.Y.*, 770 F.2d 308, 310–13 (2d Cir. 1985) (holding no civil action available under § 7, irrespective of whether the case arises under Regulation U or T).

contracts had become close substitutes for margin leverage and therefore, if the margin regulations were to be maintained, margins in the derivatives markets needed to be significantly raised. This task should be done either by self-regulatory organizations or an interagency task force involving the SEC and the CFTC.⁹³ Thereafter, despite evidence of speculation and volatility in the stock market in the middle and late 1980s, the late 1990s, and more recently, Congress did nothing with this recommendation and the Federal Reserve Board did nothing about margin rates. In view of widespread leverage accomplished through derivatives trading, raising margin rates might have been a futile gesture, but at least it would have been a warning about undue speculation and leverage in the securities markets. Moreover, excessive securities credit could have been curbed through better regulation of derivatives.

The 1987 stock market crash was a warning about the danger of uncontrolled speculation and leverage in the derivatives markets, but the Federal Reserve Board and other regulators took no action. The 508-point drop in the Dow Jones Industrial Averages on Monday, October 19, 1987 on a record high volume of over 600 million shares was an even steeper decline in stock prices than Black Thursday of October 29, 1929. The New York Stock Exchange nearly closed on Tuesday, October 20, 1987, and probably would have, but for the Federal Reserve Board's intervention and the seemingly miraculous rebound in the market at midday.⁹⁴

The culprit of market volatility most immediately identified after the crash was "program trading." This inexact term covered a variety of computer assisted trading strategies involving derivative products, particularly stock index futures. All of these strategies involved efforts to hedge against stock market risk, but functioned during the crash to increase a market decline.⁹⁵

Numerous studies conducted after the crash by government and exchange bodies⁹⁶ agreed upon little other than that the prices of stocks

93. See Letter from Paul A. Volcker, Chairman, Bd. of Governors of the Federal Reserve System, to the Honorable Jesse Helms, Chairman, S. Comm. on Agriculture, Nutrition and Forestry, (Jan. 11, 1985).

94. See James B. Stewart & Daniel Hertzberg, *Terrible Tuesday: How the Stock Market Almost Disintegrated A Day After the Crash*, WALL ST. J., Nov. 20, 1987, at A1.

95. See Thomas Lee Hazen, *Volatility and Market Inefficiency: A Commentary on the Effects of Options, Futures, and Risk Arbitrage on the Stock Market*, 44 WASH. & LEE L. REV. 789, 799-802 (1987).

96. After various exchanges issued reports, a blue ribbon Presidential Committee headed by Nicholas Brady published its report. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (1988). The SEC issued a staff report, as did the CFTC. See DIV. OF MKT. REGULATION, U.S. SEC. & EXCH. COMM'N, THE OCTOBER 1987 MARKET BREAK (1988); DIV. OF ECON. ANALYSIS &

during the crash were being established by the derivatives markets in Chicago instead of by the stock exchanges in New York and elsewhere. A presidential committee recommended that one government agency regulate intermarket issues, and suggested the Federal Reserve Board, but Alan Greenspan declined this responsibility.⁹⁷ After these reports were issued, the President appointed a Working Group on Financial Markets comprised of the Chairs of the SEC, CFTC, Federal Reserve Board, and Secretary of the Treasury (President's Working Group); it was to agree on intermarket mechanisms to prevent another crash within sixty days.⁹⁸ The President's Working Group, however, was unable to agree to raising margin rates or otherwise address stock market leverage.⁹⁹

The collapse of Long Term Capital Management (LTCM) was another warning sign of excessive securities credit and poor OTC derivatives' regulation. LTCM was an investment vehicle for a number of hedge funds. It began with a capital base of \$5 billion and its principals included a former vice-chair and bond trading chief at Salomon Brothers, Inc. and two Nobel laureates in economics.¹⁰⁰ Its portfolio was extraordinarily large and risky. Approximately 80% of LTCM's balance-sheet positions were in treasury securities of the major industrial countries and this portfolio, as of the end of 1997, was leveraged 28-to-1. But its off-balance-sheet activities and use of derivatives made its activities more leveraged and risky. By August 1998, LTCM had approximately \$1.4 trillion in notional value of derivatives off-balance sheet on a capital base of approximately \$2.3 billion. When Russia devalued the ruble and declared a debt moratorium in August 1998, LTCM became highly vulnerable to the market conditions that ensued and by September had lost almost 50% of its equity. The Federal Reserve Board was required to intervene because of the systemic threat that LTCM's collapse would have posed to the capital markets. Although the Federal Reserve Board did not lend money to LTCM itself, it facilitated a private sector recapitalization of

DIV. OF TRADING AND MKTS., COMMODITY FUTURES TRADING COMM'N, INTERIM REPORT ON STOCK INDEX FUTURES AND CASH MARKET ACTIVITIES DURING OCTOBER 1987 (1987).

97. "Black Monday," *The Stock Market Crash of October 19, 1987: Hearings before S. Comm. on Banking, Hous., & Urban Affairs*, 100th Cong. 98-99 (1988) (testimony of Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys.).

98. *White House Issues Order Creating Working Group on Financial Markets*, 20 Sec. Reg. & L. Rep. (BNA) 452 (Mar. 25, 1988); Exec. Order No. 12,631, 53 Fed. Reg. 9421 (Mar. 18, 1988).

99. SEC Chairman David Ruder dissented from the Report on this ground.

100. Paul N. Roth & Brian H. Fortune, *Hedge Fund Regulation in the Aftermath of Long-Term Capital Management*, in *HEDGE FUNDS: LAW AND REGULATION* 83 (Iain Cullen & Helen Parry eds., 2001).

LTCM composed of fourteen banks and securities firms, which were LTCM's largest creditors.¹⁰¹

As was the case with the 1987 stock market crash, a number of governmental, international, and private sector groups were convened to study the financial crisis; several bills were introduced in Congress but little happened. The general consensus of these various reports was that LTCM's counterparties took undue risks and ignored their own credit risk parameters, but that regulators should rely on transparency and market forces to improve risk management by institutional investors. Many reports noted the "regulatory gap" between the SEC and the CFTC and paid homage to greater regulatory coordination,¹⁰² but did not recommend regulating hedge funds. A President's Working Group report specifically declined to recommend the direct regulation of unregulated hedge funds or derivatives dealers on the grounds that regulation would drive these entities offshore.¹⁰³

Alan Greenspan, as Chairman of the Federal Reserve Board, embraced derivatives because he believed they were good for banks because they spread risk.¹⁰⁴ He argued that derivatives were essential to the stability of the banking system and therefore should not be regulated.¹⁰⁵ Further, Greenspan attributed the substantial increase in U.S. wealth and productivity in part to the derivatives markets.¹⁰⁶ But by keeping interest rates too low, the Federal Reserve Board fueled a stock market bubble and then a credit bubble.¹⁰⁷ Further, derivatives trading completely undermined the SEC's short sale rule and the margin regulations. Blaming the Federal Reserve Board is no more useful than blaming the SEC for the meltdown in the financial markets, but it is troubling that many recommendations for regulatory reform involve giving the Federal Reserve Board more power and responsibility than it has now.¹⁰⁸ By refusing to regulate securities credit, and keeping

101. *Id.* at 85–87.

102. U.S. GEN. ACCOUNTING OFFICE, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK 24 (1999).

103. PRESIDENT'S WORKING GROUP ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 32–41 (1999).

104. David Blake, *Greenspan's sins return to haunt us*, FIN. TIMES, Sept. 19, 2008, at 17.

105. Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1023–24 (2007).

106. Kai Kramer, Comment, *Aren't We Still in the "Garden of the Forking Paths"?* A Comment on Consolidation of the SEC and CFTC, 4 HOUS. BUS. & TAX L.J. 410, 417 (2004).

107. See Greg Ip, *In Treating U.S. After Bubble, Fed Helped Create New Threats*, WALL ST. J., June 9, 2005, at A1.

108. One critic, noting that the Federal Reserve Board has not taken as much heat from Congress as the SEC, quipped that "[s]ometimes nothing succeeds like failure." Floyd Norris, *Failing Upward at the Fed*, N.Y. TIMES, Feb. 27, 2009, at B1, B4; see also Allan H. Meltzer, *Keep the Fed Away From the*

interest rates too low, the Federal Reserve Board was as complicit in encouraging such risks as was either the SEC or CFTC. Further, Congress and the Executive were more complicit by bowing to the political winds urging deregulation of financial services.

IV. THE SEC AS A PRUDENTIAL AND MARKET REGULATOR

A. Broker-Dealer Capital Adequacy

The SEC's mandate has never been to prevent the stock market from falling, and in the past, no broker-dealer was considered too big to fail. If an investment bank mismanaged its business, it was forced into bankruptcy. The securities laws were designed only to protect customer funds and fully paid for securities held by brokers as custodians. Yet, broker-dealers were required by the Exchange Act, to maintain a certain level of capital adequacy as a cushion against financial failure.

In 1975, the SEC became responsible for administering the net capital rule for all broker-dealers.¹⁰⁹ Generally, this rule required broker-dealers to maintain a debt-to-net capital ratio of 15-to-1.¹¹⁰ But this rule did not apply to the parent of a broker-dealer or to sister subsidiaries. In April 2004, SEC Chair William Donaldson and SEC commissioners undertook the Consolidated Supervised Entities Program (CSE). The background for this change was that the Gramm-Leach-Bliley Act,¹¹¹ which eliminated the separation of investment and commercial banking, made no provision for regulating broker-dealer holding companies similar to the Federal Reserve Board's supervision of bank holding companies.¹¹² After the European Union threatened to become the consolidated regulator of U.S. broker-dealer holding companies, the SEC undertook this task, but on a voluntary basis. That is, the five

Investment Banks, WALL ST. J., July 16, 2008, at A17.

109. Prior to that time, the New York Stock Exchange administered the net capital rule for NYSE member firms, but after the back office crisis and numerous bankruptcies of the late 1960s and early 1970s, and passage of the Securities Investor Protection Act, the stock exchanges no longer had responsibility for formulating or enforcing this rule. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 458-60 (Houghton Mifflin 1982).

110. Compare 17 C.F.R. § 240.15c3-1(a) (2009) with 17 C.F.R. § 240.15c3-1(a)(7) (2009) and 17 C.F.R. § 240.15c3-1e (2009). See also Julie Satow, *Ex-SEC Official Blames Agency for Blow-Up of Broker-Dealers*, N.Y. SUN, Sept. 18, 2008, at 1.

111. Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 7, 11, 12, 15, 16 U.S.C.).

112. *But see* Market Reform Act of 1990, Pub. L. No. 101-432, 104 Stat. 963 (codified as amended at 15 U.S.C. 78m, 78q (2006)) (passed after the bankruptcy of Drexel Burnham Lambert, requiring broker-dealers to file regulatory reports on their financing, capital risk management policies, and pending legal proceedings).

largest companies at the time agreed to have the SEC become their supervisor, even though there was no statutory authority for such regulation.¹¹³ Under this regime, these firms were permitted to transfer billions of dollars of reserves against capital to their parent holding companies for investment in mortgage backed-securities, credit derivatives, and other exotic instruments.¹¹⁴ As a result, by the time Bear Stearns collapsed, the ratios of four of the five firms subject to the consolidated regulation program was in the neighborhood of 30-to-1, although none violated the net capital rule.¹¹⁵ SEC Chair Cox conceded that the SEC's inadequate oversight of consolidated broker-dealers, including Bear Stearns and Lehman Brothers, contributed to the financial crisis.¹¹⁶ He also noted that the SEC's program of oversight over broker-dealer holding companies was a voluntary program and therefore was "fundamentally flawed from the beginning."¹¹⁷ But the SEC's program was consistent with the supervision of bank capital adequacy, which allowed banks to comply with internally generated risk measurements.¹¹⁸

In 2008, the Federal Reserve Board and the Treasury decided that the option of bankruptcy for some large investment bank holding companies was no longer good policy. If that is to remain the case, broker-dealer holding companies should be regulated like other financial institutions considered too big or too interconnected to fail, but this is essentially utility regulation. Leverage and risk-taking will have to be severely curtailed. This may be the proper regulation for commercial banks, but it may not be the best long-term regulation for investment banks, because they are supposed to act as underwriters of risk in the capital formation process and as traders of securities in the secondary markets for price discovery and liquidity objectives.

113. See *Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions: Hearing before the S. Comm. on Banking, Hous. & Urban Affairs*, 110th Cong. 6 (2008), available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=c17161d3-a5f7-4544-9ade-7dc2197ddce0 [hereinafter *Turmoil in U.S. Credit Markets*] (testimony of Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n).

114. Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. TIMES, Oct. 3, 2008, at A1.

115. *Id.* at A23.

116. See Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 27, 2008, at A1.

117. *Id.*

118. See *Review of Investor Protection and Market Oversight with the Five Commissioners of the Securities and Exchange Commission: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 79-80 (2007), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_house_hearings&docid=f:37560.pdf (statement of the U.S. Sec. & Exch. Comm'n).

Although there seems to be a growing consensus that systemic risk¹¹⁹ regulation should be assumed by either the Federal Reserve Board or a new regulator, rearranging the regulatory chairs is not as important as changing the substance of the net capital rule applicable to broker-dealers. Risks to the whole enterprise, and not just risks to the broker-dealer entity should be considered in any capital adequacy rules. Off-balance-sheet accounting should not be permitted. Financial institutions should not be allowed to establish their own risk standards and then manage to those standards.

There remains a question as to whether a central banker should assume the role of a systemic and prudential regulator for all large financial institutions because of the serious conflicts of interest involved. The Department of the Treasury is a political department of the Executive Branch, and also the issuer of U.S. government debt. So the question of how and by whom systemic and prudential regulation should be crafted and administered is not simple—especially if one believes, as I do, that such regulation should be entrusted to an independent agency. Regulators are reluctant to enforce capital adequacy rules against a major financial institution or to close down any firm. Politicians are even more reluctant. Only a strong, independent regulator stands any chance of being firm enough to pierce a financial bubble before it explodes.

There is support for a new systemic risk regulator for all large financial institutions, and another (or the same) prudential regulator to enforce risk regulations. One remaining question is whether or how new regulations for hedge funds should be allocated between the SEC or such a new regulator. Professor Coffee has suggested that a systemic risk regulator should have the authority to: limit the leverage of financial institutions and prescribe mandatory capital adequacy standards; approve, restrict, and regulate trading in new financial products; mandate clearing houses; mandate write downs for risky assets; and intervene to prevent and avert liquidity crises.¹²⁰ But as he points out, there are over 5,000 registered broker-dealers in the United States and it would be infeasible for a systemic risk regulator to oversee all of them.¹²¹ It is unclear whether the SEC is capable of doing so, particularly if hedge funds are added to the mix of intermediaries

119. Systemic risk is risk to an entire financial system or market, as opposed to the collapse of one firm within that market. Kathleen A. Scott, *Addressing the Conditions Leading to 'System Risk' on a Global Basis*, N.Y. L.J., Mar. 18, 2009, at 3.

120. John C. Coffee, Jr., *A Systematic Risk Regulator? Who, What and Why?*, N.Y. L.J., Mar. 19, 2009, at 5.

121. *Id.*

already subject to SEC surveillance. Professors Coffee, Sale, and Fisch have argued that the SEC did not do an adequate job of prudential or systemic regulation with regard to the CSE program, and that the SEC may not be capable of such a role.¹²²

Because there is little consensus as to whether any existing regulatory agencies have shown sufficient expertise and backbone to curtail systemic risk, one idea gaining traction is a council of existing regulators to oversee risk in the financial markets. SEC Chair Mary Schapiro and FDIC Chair Sheila Bair have both endorsed such an idea.¹²³ The Obama Administration also has proposed such a council, dubbed the Financial Services Oversight Council, but as an agency to complement the Federal Reserve Board acting as a systemic regulator.¹²⁴ This proposal has since been adopted by the House Committee on Financial Services.¹²⁵ At first blush this seems to be a warmed over and expanded version of the President's Working Group, formed after the 1987 stock market crash, which has accomplished little. But in this new and different political climate, such a council might be more activist.

B. Credit Derivatives

Credit default swaps are a financial contract with a value based on underlying debt obligations. They transfer risk rather than raise capital. A credit default swap can be tied to the performance of the debt obligations of a single issuer, or an index of multiple issuers.¹²⁶ These are generally structured as OTC derivative contracts so that they will be subject to the "swap exclusion" from the definition of "securities" under the Securities Act and the Exchange Act, and therefore not subject to SEC regulation.¹²⁷ Further, when Brooksley Born was CFTC Chair and tried to regulate credit default swaps, Alan Greenspan and then-Treasury

122. See John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707 (2009); Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785 (2009).

123. See Andrew Ackerman, *A Council of Regulators*, THE BOND BUYER, May 11, 2009. The Treasury Department has proposed a new, independent, systemic regulator. Press Release, Department of the Treasury, Treasury Outlines Framework for Regulatory Reform (Mar. 26, 2009), available at <http://www.financialstability.gov/latest/tg72.html>.

124. TREASURY WHITE PAPER, *supra* note 28, at 20.

125. H.R. 4173, 111th Cong. (2009).

126. *Hearing to Review the Role of Credit Derivatives in the U.S. Economy: Hearings Before the H. Comm. on Agric.*, 110th Cong. 14, available at <http://agriculture.house.gov/testimony/110/110-49.pdf> [hereinafter *Role of Credit Derivatives*] (prepared statement of Erik Sirri, Director, Div. of Trading and Mkts., U.S. Sec. & Exch. Comm'n).

127. *Id.* at 17; see also 15 U.S.C. § 78c-1 (2006); Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 7, 11, 12, 15, 16 U.S.C.).

Secretary Robert Rubin blocked such regulation on the ground that it would precipitate a financial crisis.¹²⁸ Congress then exempted OTC derivatives from CFTC regulation.¹²⁹

Credit derivatives operate functionally as short sales of bonds with virtually unlimited risks.¹³⁰ This is because the buyer of a credit default swap does not have to own the bond or any other debt instrument upon which such a contract is based. So buyers can purchase a “naked short” on the debt of companies without any restrictions.¹³¹ Warren Buffet has called derivatives “financial weapons of mass destruction”¹³² and George Soros has contended that new derivatives should be regulated like initial public offerings.¹³³ The head of the New York State Insurance Department called credit derivatives “legalized gambling.”¹³⁴ As outgoing Chair of the SEC, Christopher Cox recommended that they brought under immediate regulatory control.¹³⁵ The current SEC Chair, Mary Schapiro, has similarly argued for their regulation.¹³⁶ In addition to the role of credit derivatives in bringing down Bear Stearns, Lehman Bros., and other investment banks,¹³⁷ the rescue of AIG, the world’s largest insurance company, cost the U.S. taxpayer \$150 billion because of AIG’s holdings of credit derivatives.¹³⁸

128. CONGRESSIONAL OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM 14 (2009). Afterwards, she continued to warn about the danger of derivatives trading. See Brooksley Born, *International Regulatory Responses to Derivatives Crises: The Role of the U.S. Commodity Futures Trading Commission*, 21 NW. J. INT’L L. & BUS. 607, 636–37 (2001); see also Richard B. Schmitt, *The Born Prophecy*, A.B.A. J., May 2009, at 50.

129. Legal Certainty for Bank Products Act of 2000, tit. IV, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended at 7 U.S.C. §§ 27–27f (2006)).

130. George Soros, *The game changer*, FT.COM, Jan. 28, 2009, <http://www.ft.com/cms/s/0/09b68a14-eda7-11dd-bd60-0000779fd2ac.html>.

131. See *Turmoil in U.S. Credit Markets*, *supra* note 113, at 7 (testimony of Christopher Cox, Chairman, U.S. Sec. & Exch. Comm’n).

132. Warren Buffet, *Chairman’s Letter*, in BERKSHIRE HATHAWAY, INC., 2002 ANNUAL REPORT 15 (2002), available at <http://www.berkshirehathaway.com/2002ar/2002ar.pdf>; see also Darrell Duffie, *Derivatives and Mass Financial Destruction*, WALL ST. J., Oct. 22, 2008, at A17.

133. Soros, *supra* note 130.

134. See Shannon D. Harrington, *DTCC May Raise Credit-Default Swap Disclosure Amid Criticism*, BLOOMBERG, Oct. 31, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a11F5ibQBk9w&refer=home>.

135. *Turmoil in U.S. Credit Markets*, *supra* note 113, at 7 (testimony of Christopher Cox, Chairman, U.S. Sec. & Exch. Comm’n).

136. Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, Address to Practising Law Institute’s “SEC Speaks in 2009” Program (Feb. 6, 2009), available at <http://www.sec.gov/news/speech/2009/spch020609mls.htm>.

137. See Kara Scannell, *SEC Faulted for Missing Red Flags at Bear Stearns*, WALL ST. J., Sept. 27, 2008, at A3.

138. See Mary Williams Walsh, *A Remake of A.I.G. Is the Goal of Rescue*, N.Y. TIMES, Mar. 3, 2009, at B1; Andrew Ross Sorkin, *The Case For a Giant, By a Giant*, N.Y. TIMES, Mar. 3, 2009, at B1.

Some believe that credit default swaps should be regulated as commodities futures and forced on to commodities exchanges. Others believe that credit default swaps should be forced into centralized clearinghouses.¹³⁹ If such swaps become standardized, however, they would lose their exemption from CFTC and SEC regulation.¹⁴⁰ Accordingly, the international SRO for swaps in the derivatives market has long fought against their standardization and regulation.¹⁴¹

Whether regulation of credit default swaps is given to the SEC or the CFTC, or a combined agency, their future regulation appears inevitable. The question is whether this regulation should take the form of mandating transparency, compelling clearing through a recognized clearing agency, or allowing only certain approved instruments to be floated. Commodity exchanges could be given a monopoly on trading credit default swaps if they become regulated as standardized commodities. Before 2000, the CFTC would not have been able to approve such trading until these instruments were tested for their intrinsic merit and shown that they had an economic purpose and not be contrary to the public interest.¹⁴² But this requirement was gutted by the CFMA and replaced by a SRO self-certification.¹⁴³ Strengthened regulation of OTC derivatives could reinstate such an economic merit test. Some have suggested that the SEC be given powers similar to the Food & Drug Administration to rule on the safety and soundness of new derivative products, but it is unclear whether legislators will endorse such an approach.¹⁴⁴ Merging the SEC and CFTC would simplify crafting legislation appropriate for dealing with trading approvals for credit default swaps and similar products.

In May 2009, Secretary Geithner asked Congress to approve legislation that would impose new regulatory requirements on the OTC derivatives market, which would permit both the SEC and the CFTC to oversee and regulate these financial instruments.¹⁴⁵ The SEC and the

139. See, e.g., Schapiro, note 136; Duffie, *supra* note 132. The Obama Administration has proposed that swaps and other derivatives be traded on exchanges or clearinghouses backed by capital reserves. See Stephen Labaton & Jackie Calmes, *Obama Proposes a First Overhaul of Finance Rules*, N.Y. TIMES, May 14, 2009, at A1.

140. *Role of Credit Derivatives*, *supra* note 126, at 12 (statement of Erik R. Sirri, Director, Div. of Trading and Mkts., U.S. Sec. & Exch. Comm'n).

141. See *Hearing to Review Derivatives Legislation: Hearings Before the H. Comm. on Agric.*, 111th Cong. 141-43 (2009) (statement of Robert G. Pickel, Exec. Dir. & CEO, Int'l Swaps and Derivatives Ass'n).

142. Russo & Vinciguerra, *supra* note 23 at 1448, 1448 n.51.

143. See 17 C.F.R. § 40.2 (2009); see also James M. Falvey & Andrew N. Kleit, *Commodity Exchanges and Antitrust*, 4 BERKELEY BUS. L. J. 123, 166-67 (2007).

144. See, e.g., Norris, *supra* note 108.

145. Press Release, U.S. Dep't of the Treasury, Regulatory Reform of Over-The-Counter (OTC)

CFTC joined Secretary Geithner at the press conference and expressed pleasure with his proposal.¹⁴⁶ But the proposal resolves the jurisdictional tensions between these two agencies to only a limited extent. This press conference was followed by the release of the proposed Over-the-Counter Derivatives Market Act of 2009.¹⁴⁷ This proposed legislation would provide for regulation and transparency of all OTC derivative transactions; strong prudential and business conduct regulation of all OTC derivative dealers and other major participants in the OTC derivative markets; and improved regulatory and enforcement tools to prevent manipulation, fraud, and other abuses in those markets.

To reduce the risks to the financial stability that arises from the web of bilateral connections among major financial institutions, the legislation would require standardized OTC derivatives to be centrally cleared by a derivatives clearing organization regulated by the CFTC or a securities clearing agency regulated by the SEC.¹⁴⁸ This proposal has been adopted with changes by the House Financial Services Committee.¹⁴⁹ Under this proposal, the SEC will monitor swap activity and transaction data and by rule or regulation identify specific swap contracts that it determines are required to be cleared consistent with the public interest, after taking into account several factors including the existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.¹⁵⁰ The legislation would require standardized OTC derivatives to be traded on a swap execution facility registered with the SEC, or a CFTC in case of contract of sale of a commodity for future delivery or commodity option.¹⁵¹ It would encourage substantially greater use of standardized derivatives and thereby facilitate migration of OTC derivatives onto central clearinghouses and exchanges by imposing higher capital requirements¹⁵² and higher margin requirements for nonstandardized derivatives.¹⁵³ The legislation

Derivatives (May 13, 2009), available at <http://www.treas.gov/press/releases/tg129.htm>.

146. Statement, Michael Dunn, Acting Chairman, Commodity Futures Trading Comm'n, Joint Press Conference on OTC Derivatives Regulation (May 13, 2009), available at <http://www.cftc.gov/stellent/groups/public/@newsroom/documents/pressrelease/dunnstatement051309.pdf>; Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Statement at Treasury Department Press Briefing on OTC Derivatives (May 13, 2009), available at <http://www.sec.gov/news/speech/2009/spch051309mls.htm>.

147. Over-the-Counter Derivatives Market Act, *supra* note 81.

148. *Id.* § 713(a)(2).

149. H.R. 3795, 111th Cong. (2009).

150. *Id.* § 113(3).

151. *Id.* § 113(6).

152. *Id.* § 117 (e)(1)(B).

153. *Id.*

proposes a broad definition of “derivative” and “swap.”¹⁵⁴ All relevant federal financial regulatory agencies would have access on a confidential basis to the OTC derivative transactions and related open positions of individual market participants.¹⁵⁵ The public would have access to aggregated data on open positions and trading volumes.¹⁵⁶

The legislation would require federal supervision and regulation of any firm that deals in OTC derivatives and any other firm that takes large positions in OTC derivatives. Federal banking agencies would regulate OTC derivative dealers and major market participants that are banks.¹⁵⁷ A federal banking agency may except an identified banking product from the exclusion of application of Commodity Exchange Act if the agency determines, in consultation with the CFTC and the SEC, that the product would meet the definition of a security-based swap.¹⁵⁸

OTC derivative dealers and major market participants that are not banks would be regulated by the CFTC or SEC.¹⁵⁹ The federal banking agencies, CFTC, and SEC would be required to provide robust and comprehensive prudential supervision and regulation, including strict capital and margin requirements, for all OTC derivative dealers and major market participants.¹⁶⁰ The CFTC and SEC would be required to issue and enforce strong business conduct, reporting, and recordkeeping (including audit trail) rules¹⁶¹ for all OTC derivative dealers and major market participants.¹⁶²

The legislation would give the CFTC and the SEC authority to deter market manipulation, fraud, insider trading, and other abuses in the OTC derivative markets. It would give the CFTC authority to set position limits and large trader reporting requirements¹⁶³ for OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets.¹⁶⁴ The CFTC and the SEC would be required to harmonize and jointly adopt uniform rules governing persons that are registered as derivatives clearing organizations for swaps under the proposed legislation¹⁶⁵ and persons that are registered as clearing

154. *Id.* § 111(a)(35).

155. *Id.* § 115 (c)(4).

156. *Id.* § 113 (2)(L).

157. *Id.* § 403(b).

158. *Id.*

159. *Id.* § 117(e)(1)(B).

160. *Id.*

161. *Id.* § 117(g)(4).

162. *Id.* § 117.

163. *Id.* § 153, § 10B(a).

164. *Id.* § 124(a)(2).

165. *Id.* § 111(c)(1).

agencies for security-based swaps under the Exchange Act. If the CFTC and the SEC fail to jointly prescribe uniform rules and regulations in a timely manner, the Secretary of the Treasury, in consultation with the CFTC and the SEC, would prescribe rules and regulations within 180 days of the time that the CFTC and the SEC failed to adopt such rule and regulation.¹⁶⁶ The legislation does not appear to sufficiently eliminate the regulatory loopholes that allowed unregulated credit derivatives to flourish.¹⁶⁷

C. Short Sales

Regulation of short sales is another politicized topic. A short sale is the sale of any security the seller does not own or any sale consummated by the delivery of a borrowed security. A former SEC rule prohibited any person from effecting a short sale of any exchange listed security below the price at which the last sale of that security was reported.¹⁶⁸ This was known as the “uptick” rule. It was rescinded in the summer of 2007 because the SEC believed it had become unnecessary with decimal pricing and the transparency and surveillance in exchange markets.¹⁶⁹ Further, the widespread availability of options and derivatives had made the rule of questionable utility because it could be so easily evaded by trades in the futures markets. Nevertheless, after the current financial crisis was triggered by the collapse of Bear Stearns, and Lehman Bros. began to fail, there was a hue and cry about short sellers and the SEC responded by prohibiting short sales in financial stocks.

Between July 21 and August 15 the SEC restricted short sales in nineteen financial stocks.¹⁷⁰ After this emergency order expired, turmoil in the stock market continued, and financial firms claimed that their stocks were being pounded by short sellers. The SEC then banned “abusive naked short selling,” or short selling by persons who do not actually borrow stock to deliver against a sale, and fail to deliver stock to the buyer. By a temporary rule, on September 17, 2008, the SEC required short sellers and their broker-dealers to deliver securities by the close of business on settlement date and imposed penalties for failure to

166. *Id.* § 111(c)(2)

167. See Kara Scannell & Sarah N. Lynch, *SEC Seeks More Credit-Swaps Power*, WALL ST. J., Sept. 23, 2009, at C3.

168. Former rule 10a-1 under the Securities Exchange Act of 1934 was adopted in 1938 to prevent bear raids. Exchange Act Release No. 1,548, 3 Fed. Reg. 213 (Jan. 24, 1938).

169. Regulation SHO and Rule 10a-1, Exchange Act Release No. 55,970, 72 Fed. Reg. 36,348 (July 3, 2007).

170. Emergency Order, Exchange Act Release No. 58,166, 93 SEC Docket 2122 (July 15, 2008); see Mark Hulbert, *Maybe Short-Selling Isn't So Bad, After All*, N.Y. TIMES, Sept. 28, 2008, at BU9.

do so.¹⁷¹ The SEC made this ban permanent in July 2009.¹⁷²

In September 2008 the SEC banned short selling in the stocks of 799 U.S. financial sector companies, and later allowed the exchanges to add additional companies to the list.¹⁷³ Nearly 1,000 stocks went on to this list, including CVS Caremark Corp., International Business Machines Corp., General Motors Corp., and General Electric Corp.¹⁷⁴ The SEC also required hedge fund managers to disclose their short positions publicly, and announced that this requirement would be made permanent.¹⁷⁵

The SEC's short selling bans have been criticized as making a volatile market worse—a “clumsy effort to buoy shares of battered financial stocks.”¹⁷⁶ It appears that the SEC's short sale bans cut the volume in the stocks on the no-short-sale list, resulting in wide price swings. Further, despite the bans, stocks including National City Corp. and Sovereign Bancorp Inc. suffered sharp declines; Washington Mutual Inc. and Wachovia Corp. essentially failed.¹⁷⁷ SEC Chair Cox later stated that he thought the SEC's emergency short sale rules were a mistake.¹⁷⁸

Nevertheless, enormous political pressure was brought to bear on the SEC to reinstate a short sale rule.¹⁷⁹ The SEC has proposed two approaches to such a rule.¹⁸⁰ One approach is to apply a price test on a marketwide and permanent basis. This test would either be based on the national best bid or the last sale price. The second approach is a circuit breaker rule and would apply only to a particular security during a severe price decline. It is questionable whether the SEC would reinstate a short sale rule absent current political demands for such a rule,¹⁸¹

171. 17 C.F.R. § 242.204T (2008); Emergency Order, Securities Exchange Act Release No. 58,572, 94 SEC Docket 293 (Sept. 17, 2008).

172. Amendments to Regulation SHO, Exchange Act Release No. 60,388, 74 Fed. Reg. 38,266 (July 31, 2009).

173. Emergency Order, Exchange Act Release No. 58,592, 94 SEC Docket 460 (Sept. 18, 2008); Amendment to Emergency Order, Exchange Act Release No. 58,611, 94 SEC Docket 501 (Sept. 21, 2008).

174. Kara Scannell & Serena Ng, *SEC's Ban on Short Selling Is Casting a Very Wide Net*, WALL ST. J., Sept. 26, 2008, at C1.

175. Emergency Order, Exchange Act Release No. 58,591, 94 SEC Docket 312 (Sept. 18, 2008).

176. Tom Lauricella et al., *SEC Extends 'Short' Ban As Bailout Advances*, WALL ST. J., Oct. 2, 2008, at C1.

177. *Id.* at C7.

178. Rachele Younglai, *SEC chief has regrets over short-selling ban*, REUTERS, Dec. 31, 2008.

179. Mary Schapiro, President Obama's appointee for Chairman of the SEC, represented in her Senate confirmation hearing that she would quickly examine whether the uptick rule should be restored. Stephen Labaton, *S.E.C. Nominee Offers Plan for Tighter Regulation*, N.Y. TIMES, Jan. 16, 2009, at B3.

180. Amendments to Regulation SHO, Exchange Act Release No. 59,748, 74 Fed. Reg. 18,042 (proposed Apr. 20, 2009).

181. *See id.* at 18,046 nn.55–56.

because the agency has stated that it believes short selling serves useful market purposes.¹⁸² In August 2009, the SEC proposed an alternative uptick rule that would not require monitoring of the sequence of bids, and as a result might be easier to monitor.¹⁸³

Railing against short sellers seems to be efforts to shoot the messenger rather than listening to the message, but many observers believe that abusive short selling drove down the prices of financial stocks in the recent downturn. But the problem of leverage in the up market which preceded the 2008 market collapse was a more serious cause of the financial meltdown than eliminating the uptick rule. Further, there is no way to reinstate a meaningful uptick rule without limiting derivatives on stocks. The AIG credit default swaps debacle demonstrates that a short sale rule for bonds may also be justified if a new short sale rule for stocks is promulgated.

D. Hedge Funds

Since hedge funds became participants in the securities markets in the 1950s, they have endeavored to operate as unregulated entities and the SEC has been uncertain how, if at all, to regulate them. Most hedge funds in the United States are formed as limited partnerships in order to obtain flow-through tax treatment. Although most hedge funds and private equity funds meet the definition of an investment company as being “engaged primarily. . . in the business of investing, reinvesting, or trading in securities,”¹⁸⁴ they fall within exceptions to that definition either because their securities are owned by not more than one hundred persons, or their securities are owned “exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers,” and they are not making or proposing to make a public offering of their securities.¹⁸⁵

Similarly, the manager of a hedge fund or private equity fund falls within the definition of an investment advisor as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.”¹⁸⁶

182. *Id.* at 18,044.

183. Amendments to Regulation SHO, Exchange Act Release No. 60,509, 74 Fed. Reg. 42,033 (proposed Aug. 20, 2009).

184. Investment Company Act of 1940 § 3(a)(1)(A), 15 U.S.C. § 80a-3(a)(1)(A) (2006).

185. *Id.* §§ 3(c)(1), (7)(A), 15 U.S.C. § 80a-3(c)(1)(7)(A) (2006). For this purpose, a “[q]ualified purchaser” is a natural person who owns not less than \$5,000,000 in investment securities. *Id.* § 2(a)(51)(A), 15 U.S.C. § 80a-2(a)(51)(A) (2006).

186. 15 U.S.C. § 80b-2(a)(11) (2006).

There is an exemption from registration as an investment adviser for small advisors who have had fewer than fifteen clients, do not hold themselves out generally to the public as an investment adviser, and do not act as an investment adviser to any registered investment company.¹⁸⁷ The key to the long-time exemption for hedge funds and other private investment funds doing business as limited partnerships was that the managing partner was considered to have only one client—the limited partnership.¹⁸⁸ This safe harbor was adopted in 1985,¹⁸⁹ but the SEC attempted to eliminate it by a rule changing the definition of the term “client,” so that each shareholder or beneficiary of a private fund would be considered a separate client in counting the fifteen clients for an exemption under the Investment Advisers Act.¹⁹⁰ Two SEC commissioners dissented from the promulgation of this rule,¹⁹¹ leading to an appeal. The D.C. Circuit Court in *Goldstein v. SEC*¹⁹² struck down the rule as beyond the SEC’s authority. This situation challenged the SEC and Congress to decide whether the securities laws needed to be amended to give the SEC authority to regulate hedge funds.

This challenge was taken up by Senators Grassley and Levin who have introduced the Hedge Fund Transparency Act,¹⁹³ which would give the SEC authority to regulate all pooled investment vehicles that manage at least \$50 million in assets as investment companies, including hedge funds. This is a different and potentially much broader authority than the SEC sought in its 2004 rulemaking. Whether such a bill would become law, however, remains unclear because of the vagaries of current regulatory reform legislation.¹⁹⁴

The Obama Administration proposed legislation to regulate the advisors to hedge funds and force them to register with the SEC.¹⁹⁵ This

187. 15 U.S.C. § 80b-3(b)(3) (2006).

188. 17 C.F.R. § 275.203(b)(3)-1 (2006), *invalidated by* *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). The safe harbor provided for in this rule would also apply to private funds doing business as corporations, LLCs, or trusts.

189. Definition of “Client” of an Investment Adviser for Certain Purposes Relating to Limited Partnerships, Investment Advisers Act Release No. IA-983, 50 Fed. Reg. 29206 (July 18, 1985). The initial safe harbor was an effort to clarify that a general partner to a limited partnership was advising the partnership and not the partners individually.

190. Registration Under the Advisers Act of Certain Hedge Fund Advisers; Final Rule, Investment Advisers Act Release No. IA-2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004). Private equity and venture capital funds were exempted.

191. *Id.* at 72,089 (Commissioners Glassman and Atkins, dissenting).

192. 451 F.3d at 882–84.

193. S. 334, 111th Cong. (2009).

194. See Kara Scannell, *Frank Backs Regulator for Systemic Risk*, WALL ST. J., Feb. 4, 2009, at C3.

195. U.S. Dep’t of the Treasury, Registration of Advisors to Private Funds (2009), [http://www.treasury.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%](http://www.treasury.gov/press/releases/reports/title%20iv%20reg%20advisers%20priv%20funds%207%20)

proposal has been considered by the House Committee on Financial Services.¹⁹⁶ This statute would eliminate the private advisor exemption for all but certain foreign advisors and would require all domestic advisors with assets under management of more than \$150 million to register with the SEC.¹⁹⁷ The proposal would also remove the provision of the Investment Advisors Act of 1940¹⁹⁸ that prohibits the government from requiring investment advisors to disclose the identity, investment, or affairs of any client (other than in connection with enforcement matters), and would grant the SEC such reports about private funds “as are necessary or appropriate in the public interest and for the assessment of systemic risk.”¹⁹⁹ It would also require advisers to provide the SEC reports, records, and documents to investors, prospective investors, counterparties, and creditors of the private funds they advise.²⁰⁰ The SEC would then share these documents with the Federal Reserve Board and with any other entity that the SEC would identify as having systemic risk responsibility.²⁰¹ This proposed bill would explicitly allow the SEC to define terms in the Investment Advisors Act through its rulemaking authority, and thus reverse *Goldstein*.²⁰²

If hedge funds are to be regulated as investment advisors, the Bernie Madoff scandal and other Ponzi schemes have raised the question of how regulation of investment advisors should be reformed. The issue is not simply lax or incompetent enforcement by the SEC—as members of Congress trying to slough off their responsibility for the financial meltdown would have the public believe. Rather, the Investment Advisors Act has long been a skimpy and inadequate statute, and the SEC staff available for inspections of investment advisors is too small and not sufficiently sophisticated. Advisors have no other regulator, as they are not required to be FINRA members, as are broker-dealers.

There are two grounds for regulating hedge funds. First, not all their customers are as sophisticated as the SEC has assumed, and many need to be protected to the same extent as other public investors. Second, the very large hedge funds pose a systemic risk to the financial system. Some reform proposals would require all hedge funds to register with the SEC, probably as investment advisors, but possibly as Investment

2015%2009%20fnl.pdf. (last visited February 28, 2010) [hereinafter Registration of Advisers].

196. H.R. 3818, 111th Cong. (2009).

197. *Id.* § 403, H.R. 3818, 111th Cong. § 3 (2009), 15 U.S.C.A. § 80b-3a. (2006).

198. 15 U.S.C. §§ 80a-1–80b-2 (2006).

199. Registration of Advisers, *supra* note 195, at §§ 404(b), 405, H.R. 3818, 111th Cong. § 4 (2009).

200. *Id.*

201. H.R. 3818, 111th Cong. § 4 (2009).

202. H.R. 3818, 111th Cong. § 7 (2009).

Companies.²⁰³ Other proposals would require all hedge funds above a certain size to be regulated by a financial stability regulator, along with bank holding companies, investment bank holding companies, and insurance holding companies with assets over a designated dollar amount.²⁰⁴ One problem with creating such a financial stability regulator is that sometimes small financial institutions create systemic risks.²⁰⁵ Regardless of whether large hedge funds come under the surveillance of a systemic regulator, hedge fund managers should be required to register with the SEC as investment advisers, as recommended by the Obama Treasury Department. Further, in order to strengthen investment advisor regulation, forcing investment advisers into an SRO, as broker-dealers are forced to join FINRA, should be considered.

V. CONCLUSION

Consolidating the SEC and the CFTC would lead to better regulation of the markets for several reasons. First, the jurisdictional squabbling between these agencies that led to the de-regulation of credit default swaps and other OTC derivatives would end and the agency could concentrate on what regulation is in the public interest and not the interest of their own agencies and congressional oversight committees' interests. The combined agency must consider what products have an economic function for the general economy and not simply the exchanges trading them; what investor protections are needed in the securities and commodities markets; how to curb excessive speculation; and how to prevent systemic risk. Even if new systemic or prudential regulators are created, or the Federal Reserve Board regulates the capital adequacy of large investment bank holding companies and hedge funds, the SEC or a consolidated SEC-CFTC will still need to focus on preventing systemic risk in the markets and safeguarding customer securities and funds held by broker-dealers and others.

Second, a consolidated SEC and CFTC would be a bigger, and presumably more prestigious and powerful agency than either the SEC or CFTC, separately and therefore better able to guard against agency

203. See Hedge Fund Transparency Act of 2009, S. 334, 111th Cong. (2009).

204. Press Release, U.S. Dept. of Treasury, Treasury Outline Framework For Regulatory Reform (Mar. 26, 2009), available at <http://www.ustreas.gov/press/releases/tg72.htm>.

205. The 1974 collapse of Bankhaus Herstatt, a small German bank sent shock waves throughout the global financial system. See 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES 20 (2002).

capture.²⁰⁶ The day after President Obama's inauguration, the Government Accounting Office released a framework for assessing financial regulatory reform proposals.²⁰⁷ It proposed the following analytical standards: clearly defined regulatory goals that are sufficiently comprehensive and have a system-wide focus; a regulatory system that is both flexible and adaptable, and efficient and effective; consistent consumer and investor protection standards; and consistent financial oversight and minimal taxpayer expense. One of the most important points in this framework is that "[r]egulators should have independence from inappropriate influence, as well as prominence and authority to carry out and enforce statutory missions."²⁰⁸

Third, as a former SEC commissioner, I lament the criticism of the SEC during the financial crisis and hope that the agency will be reinvigorated and returned to its former position of prestige and respect. Change in the SEC's organization and mandates for its regulation would assist in this regard. As a believer in the value of independent agency regulation, I think that putting all regulatory functions into one or two executive branch agencies is a bad idea. Having a super-regulator for financial institutions is appealing because responsibility for errors can be assigned, banking, securities origination and trading, commodities trading, and insurance underwriting are not really the same businesses and should not necessarily be regulated identically. Yet our financial regulatory system is balkanized so that all regulators are responsible for the current crisis, and yet no single regulator is responsible. Accordingly, some consolidation, particularly of the SEC and CFTC, would help address this problem.

In the absence of consolidation of the SEC and CFTC (and a similar consolidation of all the federal banking agencies, a topic not discussed in this Article), it is essential that financial regulators better coordinate and harmonize their regulations. Allowing regulated entities to choose their regulators is a prescription for weak regulation. Further, when regulators engage in boosterism for industries they are supposed to be regulating, the regulatory system is corrupted. This does not mean that regulators should view every regulated entity with suspicion and as a target for enforcement action, but with a healthy skepticism of industry claims about how damaging regulation will be.

206. See *Regulatory Restructuring and Reform of the Financial System: Hearing Before H. Comm. on Fin. Servs.*, 110th Cong. 143 (2008) (testimony of Joel Seligman).

207. U.S. GEN. ACCOUNTING OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM (2009).

208. *Id.* at 2.

For about the past decade, regulators have been too willing to credit claims by financial firms that their businesses will move offshore if U.S. regulation is too tough. Although U.S. regulators must manage the challenges of globalization in structuring new regulation to deal with the aftermath of the current crisis,²⁰⁹ the financial meltdown in the United States has demonstrated that when regulation in the United States fails, the entire global financial system suffers. This should be sufficient deterrence to regulatory competition between major market regulators that need to cooperate to improve the regulation of all financial institutions. If the United States improves its faulty regulatory system, it can lead the way to better regulation everywhere.

This Article argues that regardless of the SEC's future organization, securities credit needs to be curtailed; broker-dealer capital adequacy rules need to be revised; OTC derivatives need to be regulated; the SEC should consider a new short sale rule; hedge fund managers should be required to register with the SEC as investment advisors; and investment advisor regulation should be improved. This a huge agenda, and while some of these tasks could, and may, be given to a new (hopefully independent) financial stability regulator, most of this work should, and probably will, fall to either the SEC or a combined SEC and CFTC.

209. See Luigi Zingales, *The Future of Securities Regulation*, (Chicago Booth School of Business, Working Paper No. 08-27), available at <http://ssrn.com/abstract=1319648>.

