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# WHY THE SEC FAILED: REGULATORS AGAINST REGULATION

*Norman S. Poser\**

## INTRODUCTION

In June 2009, the Securities and Exchange Commission (SEC or Commission) marks its seventy-fifth birthday. The anniversary comes at a time when the reputation and effectiveness of the agency are at their lowest point in its history. This is especially sad because the SEC was known for years as one of the finest, if not the finest, of the federal regulatory agencies. Its effectiveness as the nation's principal securities regulator was a source of pride to its members and its employees and a source of comfort to investors. Furthermore, it was thought to be incorruptible. Professor William L. Cary, SEC Chairman in the early 1960s, attributed the Commission's success to the fact that "it does not give away property rights, and has not actually engaged in the fixing of rates. . . . Nor is it an arbiter between competitors . . . ." <sup>1</sup>

Although Professor Cary's observation is still largely true, the Commission has been corrupted in ways that he probably never envisioned. Two of the SEC's most notorious failures came to light in 2008: the demise of several of the largest investment banking firms under its regulatory care and the SEC's disregard of the warning signs that could have alerted it to Bernard Madoff's \$50 billion Ponzi scheme. <sup>2</sup> These are only the most recent results of a rot that set in several years earlier. Although several partial explanations have been given for the SEC's decline, including budgetary problems and a fragmented regulatory system that has not kept up with developments in the financial markets, the main reason for the decline is that the Commission succumbed to the anti-regulatory climate of recent years. Too many of its members just did not believe in regulation. Other regulatory agencies also suffered from the same ill; but in view of the SEC's former excellence, its decline is particularly lamentable.

Ironically, there are close similarities between the state of the nation's securities markets and economy at the present time and at the time of the SEC's birth. In 1934, the country was in the worst depression in its history.

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1. WILLIAM L. CARY, *POLITICS AND THE REGULATORY AGENCIES* 4 (McGraw-Hill, Inc. 1967).

2. Diana B. Henriques & Jack Healy, *Madoff Goes to Jail After Guilty Pleas*, N.Y. TIMES, Mar. 13, 2009, at A1.

Thirteen million people, representing 25 percent of the workforce, were unemployed.<sup>3</sup> The Great Crash of 1929 and its aftermath, which wiped out 83 percent of the value of the stocks listed on the New York Stock Exchange (NYSE or Exchange), was still fresh in people's minds.<sup>4</sup> True, in early 2009 the country's financial and economic situation is not as bad as it was in 1934, but it is bad enough: the stock market has given up its gains of the previous ten years,<sup>5</sup> and the economy is sliding into a deepening recession, marked by sharply rising unemployment, foreclosures on homes, and a decline in corporate profits.

The framers of the Securities Exchange Act of 1934 (1934 Act or Exchange Act)<sup>6</sup> saw a close connection between protecting investors and maintaining a healthy economy. The introductory section of the 1934 Act points out that "excessive speculation" affects the national welfare, with the result that "the Federal Government is put to such great expense as to burden the national credit."<sup>7</sup> Therefore, securities transactions "are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions."<sup>8</sup> Today, after a speculative binge in mortgage-backed securities has been followed by the collapse of several investment banking firms and the outpouring of government funds to save the economy from disaster, that statutory language seems eerily prophetic.

In recent years, the SEC did not provide the regulation and control that might have prevented the worst results of the speculative binge of the first decade of the twenty-first century. Its failures were of two kinds. First, succumbing to the deregulatory climate that pervaded the government since the 1980s, the SEC dismantled crucial parts of the regulation established to protect investors and the markets. Second, the SEC failed to detect and stop widespread abuses by securities firms, costing investors billions of dollars.

This article will summarize the background of SEC regulation, describe the most important of the SEC's regulatory and enforcement failures, attempt to ascertain the reasons for these failures, and recommend steps that should be taken to reverse the SEC's decline.

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3. FREDRICK E. HOSEN, *THE GREAT DEPRESSION AND THE NEW DEAL* 257 (McFarland & Co., Inc. 1992).

4. *Id.*; ROBERT A. CARO, *THE YEARS OF LYNDON JOHNSON: THE PATH TO POWER* 245 (Alfred A. Knopf, Inc. 1981).

5. In 2008 alone, the Standard & Poor's 500 Index fell by 38.5 percent. *See* E.S. Browning, *WALL ST. J.*, Jan. 2, 2009, at R1; *see also Falling Backward: Stocks Finish 2008 Below Levels of 10 Years Ago*, available at [http://s.wsj.net/public/resources/documents/WSJ\\_YE2008-LEDE.pdf](http://s.wsj.net/public/resources/documents/WSJ_YE2008-LEDE.pdf).

6. 15 U.S.C. § 78a et seq.

7. Exchange Act, § 2, 15 U.S.C. § 78b (2006).

8. Exchange Act, § 2, 15 U.S.C. § 78b.

## I. BACKGROUND

The Exchange Act established the SEC to administer the federal securities laws.<sup>9</sup> Its first chairman, Joseph Kennedy, was one of Franklin D. Roosevelt's few business supporters when he ran for President in 1932. The appointment was not without its critics. One Cabinet member described Kennedy, who had participated in some of the manipulative pools of the 1920s and early 1930s, as a notorious "stock market plunger."<sup>10</sup> Roosevelt answered the criticism by explaining: "Set a thief to catch a thief."<sup>11</sup> To the surprise of many, Kennedy turned out to be an effective chairman. He organized the Commission and brought in talented staff members, including two future Supreme Court Justices, William O. Douglas and Douglas's assistant, Abe Fortas.<sup>12</sup> A Yale Law School professor, Douglas was perhaps the country's foremost legal authority on corporate finance. He was tough, brilliant, and politically astute. In 1937, Roosevelt appointed Douglas as SEC Chairman.<sup>13</sup>

Although his tenure lasted only nineteen months, Douglas made his mark on the Commission. He reorganized and simplified the structure of the country's gas and electric utilities under the Public Utility Holding Company Act of 1935;<sup>14</sup> he began the regulation of the over-the-counter market through the creation of the National Association of Securities Dealers (NASD, now renamed the Financial Industry Regulatory Authority, or FINRA) under the Maloney Act of 1938;<sup>15</sup> and he imposed standards of accounting and corporate finance on publicly-owned companies. It was during Douglas's tenure that Richard Whitney, a former president of the NYSE, was caught embezzling from the NYSE's fund for support of the widows and children of deceased stock exchange members.<sup>16</sup> After SEC hearings revealed that prominent members of the Exchange had known about the thefts but had done nothing to stop them, Douglas used the Whitney scandal as an opportunity to reform the NYSE's governing structure. He forced the Exchange to install a professional staff, headed by a full-time administrator; the system became permanent and spread to all other securities-industry self-regulatory organizations.<sup>17</sup>

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9. See Exchange Act, § 4. From 1933 to 1934, the Securities Act of 1933 (1933 Act), which regulated distributions of securities, was administered by the Federal Trade Commission. With the enactment of the Exchange Act in 1934, this responsibility was moved to the SEC.

10. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 105 (The Maple Press Co., 2d ed. 1982).

11. KENNETH S. DAVIS, *FDR: THE NEW DEAL YEARS 1933-37*, at 369 (Random House, Inc. 1979).

12. SELIGMAN, *supra* note 10, at 111.

13. *Id.* at 110.

14. 15 U.S.C. § 79 (1935).

15. 15 U.S.C. § 78o-3 (1938).

16. JOHN KENNETH GALBRAITH, *THE GREAT CRASH: 1929*, at 166-72 (1955).

17. *Id.*

When Douglas left the SEC to begin his long tenure on the Supreme Court,<sup>18</sup> his successor was Jerome Frank, a judicial philosopher and ardent New Dealer who, like Douglas, was a passionate believer in the paramount goal of the securities laws: protecting investors.<sup>19</sup> According to a contemporary report, when brokers, underwriters, and lawyers “grumble about red tape, . . . ambiguous rules, ‘arrogant & upstart personnel,’ . . . Chairman Frank thinks of the 10,000,000-odd trusting U.S. investors, resolves to guard them against needless shearing.”<sup>20</sup>

With the coming of World War II, the SEC became a less relevant and forceful agency. After Pearl Harbor, with the war to be won, the administration no longer regarded securities regulation as a priority. In early 1942, the SEC was moved to Philadelphia to make room in Washington for government departments directly concerned with fighting the war. Surprisingly, the SEC was able to assist the war effort in at least one way: it helped the War Department plan bombing missions by reviewing old SEC filings of companies with factories in Germany in order to pinpoint their location.<sup>21</sup>

Nevertheless, the SEC was relegated to the government’s backburner, where it remained for some time after the war. President Harry Truman had little interest in securities regulation and tended to appoint SEC commissioners who were cronies or persons to whom he owed political favors. The SEC was considered so unimportant that it was not brought back to Washington until 1948, three years after the war ended.

Ironically, it was during the SEC’s Philadelphia exile that perhaps the most consequential event in the history of U.S. securities laws occurred. In May 1942, investigators at the SEC’s Regional Office in Boston learned that a company president was buying up shares from its shareholders without telling them of the company’s much improved earnings. The lawyers at the SEC’s Philadelphia headquarters could find no provision in the Exchange Act to stop the fraudulent purchase (as opposed to the sale) of securities. Section 10(b) of the Exchange Act was designed to outlaw fraud generally, but it could be used only if the SEC adopted a specific rule implementing it.

Milton Freeman, a young SEC attorney, quickly drafted a short, simple rule prohibiting fraud in connection with the purchase or sale of a security.

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18. Douglas served on the Court from 1939 to 1975, longer than any other justice. *See* Supreme Court of the United States, Members of the Supreme Court of the United States, <http://www.supremecourtus.gov/about/members.pdf> (last visited Feb. 5, 2009).

19. Frank was the author of *Law and the Modern Mind* (1930), a landmark of twentieth-century legal thought, in which he analyzed law from a psychoanalytical perspective. After serving two years as SEC chairman, Frank was appointed to the Second Circuit Court of Appeals.

20. *Intellectual on the Spot*, TIME MAG., Mar. 11, 1940, available at <http://www.time.com/time/magazine/article/0,9171,789708-6,00.html>.

21. Interview by Richard Phillips with Milton Kröll, in Washington, D.C. (Sept. 13, 2001), available at <http://www.sechistorical.org/museum/oralhistories/interviews/kroll.php>.

He presented the rule to the five commissioners, who simply tossed the paper on the table, saying they were in favor of it. One member simply commented: “Well, we’re against fraud, aren’t we?” Before the sun set that day, Rule 10b-5 was the law of the land.<sup>22</sup> In 1946, a federal district court held that a violation of Rule 10b-5 could be the basis for a private right of action.<sup>23</sup> As a result, the rule, which the SEC adopted in an almost absent-minded way when the war and not securities regulation was on most people’s minds, became the most important enforcement tool not only for the SEC but also for defrauded investors. The enormous body of law created by the SEC and the federal courts interpreting Rule 10b-5 is, as Chief Justice William Rehnquist aptly (though without enthusiasm) stated, “a judicial oak which has grown from little more than a legislative acorn.”<sup>24</sup>

The long sleep of the SEC during the 1940s and 1950s came to an end in 1961, when President John F. Kennedy appointed Columbia Law Professor William L. Cary as Chairman. According to SEC historian Joel Seligman, Cary “revitalized” the agency.<sup>25</sup> Soon after his appointment, Cary obtained a special appropriation from Congress to establish the Special Study of Securities Markets (Special Study), a two-year in-depth review of the markets and their regulation. The report, issued by the Special Study in 1963, led to two key changes.<sup>26</sup> First, legislation enacted in 1964 required companies whose shares were traded in the over-the-counter (OTC) market to make the same disclosures as exchange-listed companies.<sup>27</sup> Markets thrive on information, so when information became available about OTC companies, the market exploded in size. Moreover, in 1971, the NASD established the Nasdaq market, which developed into an electronic market for OTC stocks and eventually challenged the supremacy of the NYSE.<sup>28</sup>

Second, the Special Study found that the minimum rates of commissions that the NYSE and other exchanges required members to charge their customers were not only anticompetitive but were also routinely circumvented.<sup>29</sup> The SEC forced the exchanges to gradually phase out fixed commissions, and in 1975, all commission rates paid by customers

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22. The story is told in Milton V. Freeman, *Colloquium: Foreward*, 61 *FORDHAM L. REV.* 1 (1993). The Administrative Procedure Act, which requires administrative agencies to publish proposed rules for comment before adopting them, was not in effect in 1942.

23. *Kardon v. National Gypsum Co.*, 69 F.Supp. 512, 514 (E.D. Pa. 1946).

24. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

25. SELIGMAN, *supra* note 10, at ch. 10.

26. REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95 (1963).

27. Securities Amendments Act of 1964, Pub. L. No. 88-467, 78 Stat. 565 (codified as amended at 15 U.S.C. § 781).

28. Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC’s National Market System*, 56 *N.Y.U. L. REV.* 883, 894-95 (1981).

29. REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. NO. 88-95 (1963).

became subject to negotiation.<sup>30</sup> The resulting drastic reduction in transaction costs, especially those paid by institutional investors, gave an even greater stimulus to the markets; the average daily volume of share trading on the NYSE rose more than one hundred-fold between 1975 and 2008—from eighteen million to about two billion shares.<sup>31</sup>

Under the chairmanship of William Cary and his immediate successors, the SEC achieved other key enforcement and regulatory results. In the 1961 case, *In re Cady Roberts & Co.*,<sup>32</sup> the SEC held for the first time that the use of non-public information in public securities markets on behalf of a brokerage firm or its customers violated Rule 10b-5. This seminal decision set the framework for all future insider-trading regulation. Following the reasoning of *Cady Roberts*, the Second Circuit, in *SEC v. Texas Gulf Sulphur Co.*,<sup>33</sup> firmly established the Rule 10b-5 liability of corporate insiders for misuse of inside information.

Using the authority given to it by the Securities Acts Amendments of 1975, the Commission facilitated the creation of a national market for securities and the eventual automation of the securities markets.<sup>34</sup> During the 1960s, 1970s, and early 1980s, the SEC sought to keep abreast of financial and technological developments by conducting studies and issuing detailed reports on the growth of institutional investors,<sup>35</sup> the markets for put and call options,<sup>36</sup> mutual fund regulation,<sup>37</sup> and corporate disclosure requirements.<sup>38</sup> The Commission adopted rule changes that integrated the disparate disclosure requirements of the 1933 and 1934 Acts, thus

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30. *Id.* at 898–901. The prohibition against fixing commission rates is Exch. Act § 6(e), 15 U.S.C. § 78(f)(e).

31. Press Release, New York Stock Exchange, NYSE Euronext Announces Trading Volumes for December 2008 (Jan. 9, 2009), available at <http://www.nyse.com/press/1231412905832.html>; New York Stock Exchange Fact Book, *Daily Reported Share Volume*, <http://www.nyxdata.com/nysedata/asp/default.aspx?tabid=115>.

32. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

33. *See generally* *S.E.C. v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968).

34. Bowing to pressure from the NYSE, however, the SEC was unwilling to take the necessary regulatory steps that would have converted the NYSE's trading system from face-to-face trading on a trading floor into an electronic market. As a result, the U.S. securities markets lagged behind those of Europe in automation of securities trading. *See* Norman S. Poser, *The Stock Exchanges of the United States and Europe: Automation, Globalization, and Consolidation*, 22 U. PA. J. INT'L ECON. L. 497, 524–28 (2001).

35. INSTITUTIONAL INVESTOR STUDY OF THE SEC, H.R. DOC. NO. 92-64 (1971).

36. 96TH CONG., REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS TO THE SECURITIES AND EXCHANGE COMMISSION (Comm. Print 1978).

37. 89TH CONG., REPORT OF THE SEC ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH H.R. DOC. NO. 89-2337 (1966).

38. SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (THE WHEAT REPORT) (1969). *See also* Milton H. Cohen, *Truth in Securities' Revisited*, 79 HARV. L. REV. 1340 (1966).

simplifying the disclosures and reducing the regulatory costs to companies.<sup>39</sup>

Beginning in the 1980s, the SEC largely abandoned its role as an active monitor of the markets.<sup>40</sup> Increasingly, it embraced the climate of deregulation that has since pervaded the government.<sup>41</sup> The Commission's main focus changed from protecting investors to protecting the companies and investment firms that the SEC was required to regulate. The SEC's change of direction was given an air of legitimacy by Chicago-school laissez-faire scholars who argued, for example, that: (1) regulation of the markets was not needed and was even harmful because the markets were best left to regulate themselves, (2) mandatory corporate disclosure was unnecessary because the profit motive would give companies a sufficient incentive to make accurate disclosures,<sup>42</sup> and (3) regulation of market manipulation was futile because manipulation is a myth.<sup>43</sup> Others argued that the "moral hazards" that existed when commercial bankers engaged in investment banking were also a myth.<sup>44</sup> The latter argument questioned the basic premise of the Glass-Steagall Act, which mandated separation of these

39. For example, the SEC allowed seasoned companies to file short-form registration statements when making public offers of securities under the 1933 Act, which incorporated by reference the companies' 1934 Act filings. It also adopted Regulations S-K, 17 CFR §229 (non-financial information), and S-X, 17 CFR §210 (financial information), which mandate uniform disclosures to be used in 1933 Act registration statements offerings and 1934 Act annual reports and proxy statements.

40. Nevertheless, under the chairmanships of Arthur Levitt (1993–2001) and William Donaldson (2003–2005) the SEC did take important regulatory actions, including the adoption of Regulation FD (concerning corporate disclosure) and Regulation NMS (concerning the national market system). See U.S. Securities and Exchange Commission, Historical Summary: Past Chairmen and Commissioners, <http://www.sec.gov/about/sechistoricalsummary.htm> (last visited Feb. 5, 2009).

41. For example, the Food and Drug Administration has been criticized for similarly failing to protect consumers. See Lars Noah, *The Little Agency that Could (Act with Indifference to Constitutional and Statutory Strictures)*, 93 CORNELL L. REV. 901 (2008); Jennifer Wolsing, *The VIOXX Litigation: Disincentivizing Patient Safety Through Misdirected Tort Rules*, 75 DEF. COUNS. J. 217 (2008); Cameron Rhudy, *How Congress May Have Failed Consumers with the Food and Drug Administration Amendments Act of 2007*, 27 BIOTECHNOLOGY L. REP. 99 (2008).

42. See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 682–84 (1984) ("If disclosure is worthwhile to investors, the firm can profit by providing it."). The Enron and WorldCom (and many other) corporate scandals that came to light in the early 2000s may have weakened the force of this argument. For a summary of the academic debate on the necessity for mandatory corporate disclosure, see COX, HILLMAN & LANGEVOORT, *SECURITIES REGULATION: CASES & MATERIALS* 253–57 (5th ed. 2006).

43. See Paul G. Mahoney, *The Stock Pools and the Securities Exchange Act*, 51 J.FIN. 343 (1999) (arguing that the anti-manipulative provisions of the Exchange Act were enacted under a false assumption, because the stock pools of the 1920s and 1930s were not manipulative); Daniel R. Fischel & David J. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets?*, 105 HARV. L. REV. 503 (1991) (arguing that the concept of manipulation should be abandoned because manipulation cannot be satisfactorily defined).

44. See, e.g., FRANKLIN R. EDWARDS, *THE NEW FINANCE: REGULATION AND FINANCIAL STABILITY* 71 (1996) ("It is now widely accepted that Glass-Steagall restrictions are not necessary to maintain bank soundness or financial stability.").



two activities, and provided a theoretical basis for the gradual erosion of the Glass-Steagall Act and its ultimate repeal in 1999.<sup>45</sup>

Wall Street and corporate America welcomed anti-regulatory theory because it gave them a justification for the unfettered pursuit of profit, unburdened by fear of guilt or government prosecution. Their attitude was famously summed up by the fictional financier Gordon Gekko in the 1987 movie *Wall Street*, who said “greed is good.” The catastrophic events of 2007 and 2008 have, to say the least, cast a shadow of doubt over these ideas.

## II. WEAKENING THE REGULATORY SYSTEM

During the past decade, the SEC made important regulatory changes that weakened the regulatory system and turned out to be a disaster for investors, significantly contributing to the 2008 financial crisis. First, the SEC exempted the largest investment banking firms from the minimum capital requirements imposed on broker-dealers.<sup>46</sup> Second, the SEC repealed a rule designed to prevent manipulative short selling of securities.<sup>47</sup> At the same time, the Commission’s other deregulatory actions included limiting shareholder access to the proxy voting system and repeatedly urging the Supreme Court to limit investors’ ability to recover their fraud losses by means of private lawsuits.<sup>48</sup> These four deregulatory actions are discussed below.

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45. Glass-Steagall is the name given to the National Banking Act of 1933. The Supreme Court discussed the moral hazards that led to the enactment of the Glass-Steagall Act in 1933 in some detail in *Investment Co. Inst. v. Camp*, 401 U.S. 617 (1971). The revisionist theories that supported repeal of Glass-Steagall are reviewed in NORMAN S. POSER & JAMES A. FANTO, *BROKER-DEALER LAW AND REGULATION* §2.02, at 8–9 (4th ed. 2007 & Supp. 2008).

46. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 17 C.F.R. 240.15c3-1 (2004).

47. Regulation SHO and Rule 10a-1, 17 C.F.R. 242.201 (2007); *See* Release No. 34-55970 (2007).

48. The SEC made other deregulatory changes. In 1997, it reduced from two years to one year the time that a purchaser of securities in an unregistered private placement was required to hold the securities until they could be sold to the public. Revision of Holding Period Requirements in Rules 144 and 145, Securities Act Release No. 7390, 62 FR 9242 (Feb. 20, 1997). In 2007, it reduced the required holding period to six months for securities of companies required to file periodic reports with the SEC. Revisions to Rules 144 and 145, Securities Act Release No. 8869, 92 S.E.C. Docket 110 (Dec. 6, 2007). The purpose of the holding period is to ensure that the private placement is not simply a conduit for an unregistered (and therefore illegal) public offering of the securities. The SEC justified the changes by stating they would reduce the cost of capital, particularly for small business issuers.

In 2005, the SEC loosened the rules governing public offerings, permitting some companies to send investors publicity before the SEC had approved a registered offering for sale to the public. The SEC stated that the rules “will provide more timely investment information to investors without mandating delays in the offering process that we believe would be inconsistent with the needs of issuers for timely access to capital.” Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 FR 44,722, 44,722 (Aug. 3, 2005).

### A. FINANCIAL RESPONSIBILITY

The SEC's net capital rule limits the leverage that a firm can take on in its proprietary trading.<sup>49</sup> It is designed to protect the customers and creditors of a brokerage firm from losses and delays that can occur when a firm fails. Because broker-dealers typically have many outstanding contracts with each other, the rule also provides essential protection for other brokerage firms and the markets as a whole. The rule, as it was adopted in 1942, gave an exemption from net capital requirements to member firms of stock exchanges that had net capital rules of their own.<sup>50</sup> In 1975, after a financial crisis in which several large NYSE firms failed, Congress amended the Exchange Act to require the SEC to adopt minimum standards of financial responsibility that would apply to *all* broker-dealers, and as a result the SEC repealed the stock exchange exemption.<sup>51</sup>

The net capital rule defines a firm's net capital as its net worth (assets minus liabilities) minus certain deductions from net worth (colloquially referred to as "haircuts"), in order to arrive at a figure that approximates the firm's liquid net assets.<sup>52</sup> This is done by deducting from a firm's net worth: (1) all assets that cannot be readily converted into cash; and (2) a percentage of the market value of the firm's securities and other assets (to reflect the market risk of owning these instruments).<sup>53</sup> This final figure approximates the firm's liquid net assets.<sup>54</sup> A broker-dealer must at all times have net capital that meets either one of two alternative tests:<sup>55</sup> under the first test, its aggregate indebtedness may not exceed fifteen times its net capital; under the second (or alternative) test, its net capital must be at least two percent of its customer-related receivables, i.e., debt owed to the firm on margin accounts.<sup>56</sup> Most large brokerage firms choose to be regulated under the alternative test, which provides an approximation of the firms' securities business with the public.

In 2004, the SEC, with little publicity, effectively exempted the five largest broker-dealer firms from the net capital rule.<sup>57</sup> Each of these firms

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The pros and cons of these rule changes are not the issue. The point is that they were made principally in the interests of issuing corporations and insiders, and they removed protections for public investors.

49. See 17 C.F.R. § 240.15c3-1 (2008).

50. 17 CFR 240.15c3-1(b)(1)(2).

51. See Exchange Act §15(c)(3)(A), 17 U.S.C. §78o(c)(3)(A); Exchange Act Release No. 11969 (Jan. 2, 1976).

52. POSER & FANTO, *supra* note 45, at §12.02.

53. *Id.* at §12.02[A].

54. *Id.*

55. See 17 C.F.R. § 240.15c3-1(a)(1)(i) (2008).

56. See 17 C.F.R. § 240.15c3-1(a)(1)(ii).

57. The firms were Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. Two other firms with broker-dealer affiliates, Citigroup and JP Morgan Chase, were regulated by the Federal Reserve Board. SEC OFFICE OF INSPECTOR GENERAL REPORT NO.

was affiliated with an investment bank holding company (IBHC) that did business in Europe as well as the United States.<sup>58</sup> In order to comply with a European Union requirement that bank-affiliated brokerage firms be regulated on a consolidated basis, the SEC amended the net capital rule to establish “a voluntary, alternative method of computing deductions to net capital for certain broker-dealers” that were part of consolidated supervised entities.<sup>59</sup> Under the amended rule, an IBHC and its affiliated broker-dealer could elect to become a consolidated supervised entity (CSE) that would be supervised by the SEC under standards established by the Basel Committee on Banking Supervision.<sup>60</sup> In return, the broker-dealer affiliate would be exempted from the net capital rule.<sup>61</sup> All five firms opted to become CSEs.

The CSE program was enthusiastically greeted by the securities industry when the SEC first proposed it in 2003. The Securities Industry Association (SIA), the industry’s trade group, gushed: “While potentially reducing regulatory capital requirements, the proposal would require group-wide adherence to rigorous risk-management practices and introduce commission supervision of such practices, thereby reinforcing the financial integrity of broker-dealers.”<sup>62</sup> The SEC, however, adopted the program quietly, without even a press release. In announcing the change at an open meeting of the Commission, Chairman William Donaldson said the SEC would move its supervisory programs “from a command-and-control regulatory model to a more efficient and goal-oriented approach . . . by removing regulatory obstacles that tilt the playing field or impose needless costs.”<sup>63</sup>

Having allowed the largest firms under its regulation to opt out of its key financial-responsibility rule, the SEC failed to monitor them. According to Professor John Coffee:

[I]f the 2004 net capital rule changes were not intended to be deregulatory, they worked out that way in practice. The ironic bottom line is that the SEC unintentionally deregulated by introducing an alternative net capital rule that it could not effectively monitor. . . . [A] team of only three SEC staffers were assigned to each CSE firm (and a total of only 13

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446-A, SEC’S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM ix (Sept. 25, 2008) [hereinafter INSPECTOR GENERAL REPORT].

58. *Id.*

59. See generally Exch. Act Release No. 49,830 (June 8, 2004).

60. The Basel Committee on Banking Supervision provides international standards and supervision for international banking. About the Basel Committee, <http://www.bis.org/bcbs/index.htm>.

61. See Kenneth Marx, *The Ebb and Flow of the Purpose for Liquidity Under the New Capital Rule* 20–23 (Fall 2008) (unpublished manuscript, on file with author).

62. *Broker-Dealers: SIA Welcomes Proposed CSE Framework, Allowance for Alternative Capital Standards*, SECURITIES LAW DAILY, (Mar. 5, 2004).

63. William H. Donaldson, Chairman, S.E.C., Opening Statement at April 28, 2004 Open Meeting, (Apr. 28, 2004), available at <http://www.sec.gov/news/speech/spch042804whd.htm>.

individuals comprised the SEC's Office of Prudential Supervision and Risk Analysis that oversaw and conducted this monitoring effort).<sup>64</sup>

Virtually free of SEC regulation, the CSE firms took on enormous risks, using extreme leverage to invest in mortgage-backed securities and other exotic financial instruments. Their ratios of debt-to-equity ballooned: Merrill Lynch's (Merrill) to 28–1; Morgan Stanley's to 33–1.<sup>65</sup> The SEC "allowed such things as 'hybrid capital instruments' (much riskier than cash or Treasuries), subordinated debt (ditto) and even deferred return of taxes, to be counted as capital. The S.E.C. even allowed the banks to hold securities 'for which there is no ready market' as capital."<sup>66</sup> Furthermore, the SEC's Inspector General later reported that the SEC staff "became aware of numerous potential red flags prior to Bear Stearns' collapse, regarding its concentration of mortgage-backed securities, high leverage, shortcomings of risk management in mortgage-backed securities and lack of compliance . . . , but did not take actions to limit these risk factors."<sup>67</sup>

The result of the SEC's regulatory relaxation of the CSE firms, combined with its failure to monitor them, was devastating. When a steep drop in the housing market in 2007–2008 made many mortgage-backed securities worthless, the CSE firms were faced with multi-billion-dollar losses that threatened their viability or rendered them insolvent.<sup>68</sup> As a result, Bear Stearns was taken over by JPMorgan Chase (with emergency funding from the Federal Reserve Bank of New York), Lehman Brothers (Lehman) filed for bankruptcy protection, Merrill was acquired by Bank of America, and Goldman Sachs and Morgan Stanley transformed themselves into bank holding companies with the Federal Reserve Board (FRB) as their new principal regulator.<sup>69</sup>

The SEC's quietly adopted exemption of the CSE firms from the net capital rule and its failure to monitor them were contributing factors to the paralysis of the nation's credit system and the deepening of the economic recession. The SEC announced the end of the CSE program in September 2008.<sup>70</sup> SEC Chairman Christopher Cox admitted that the program was "fundamentally flawed because investment banks could opt in or out of supervision voluntarily."<sup>71</sup>

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64. John C. Coffee, Jr., *Missing in Action? Meltdown Raises Doubts About SEC Regulation*, N.Y.L.J. (2008).

65. See Marx, *supra* note 61, at 20–23.

66. Ben Stein, *Wall Street, Run Amok*, N.Y. TIMES, Apr. 27, 2008, § BU, at 1.

67. INSPECTOR GENERAL REPORT, *supra* note 57 at ix.

68. See *id.* at iv.

69. *Id.* at iv.

70. Press Release, *Chairman Cox Announces End of Consolidated Supervised Entities Program*, Release No. 2008-230 (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm>.

71. *Id.*

## B. SHORT SELLING

A short sale is essentially a bet that the market for a security will decline. Short sellers sell shares they do not own; they borrow the shares in order to deliver them to the buyer, in the hope that they will be able to buy the shares later at a lower price and return them to the lender. Short selling is not in itself illegal or unethical, but it is a technique that can be used for manipulative purposes. By repeatedly selling a company's shares short (and sometimes by simultaneously spreading negative rumors about the financial state of the company) short sellers can depress the share price. In the 1920s and 1930s, so-called "bear raiders" made a practice of using short selling for this purpose.<sup>72</sup>

The Exchange Act gave the SEC specific authority to regulate short selling.<sup>73</sup> In 1938, "after several years of considering the effect of short selling in a declining market,"<sup>74</sup> the SEC adopted a short selling rule.<sup>75</sup> The rule, known as the "tick test," prohibited a short sale at a price that was either (1) below the last sale price or (2) at the last sale price if that price was below that last different sale price.<sup>76</sup> For example, if the sequence of the last two sale prices was \$9.95, \$10.00, a short sale could not be made below \$10.00; but if the sequence of the last two sale prices was \$10.05, \$10.00, a short sale could not be made below \$10.05. Thus, short sellers could not move the price of a stock downward; they could sell short only in a rising market.<sup>77</sup>

In 2003, after the tick test rule had been in effect for sixty-five years, the SEC began considering its repeal. The Commission conducted a pilot program, in which the tick test was temporarily suspended.<sup>78</sup> The Commission's Office of Economic Analysis concluded that the price restrictions of the tick test "do not appear necessary to prevent manipulation."<sup>79</sup> In 2007, "in order to modernize and simplify short sale

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72. SELIGMAN, *supra* note 10, at 9; *see also* Regulation SHO and Rule 10a-1, Exch. Act Release No. 55970, 2007 WL 1880054, at n. 33 (June 28, 2007).

73. 15 U.S.C. § 78j.

74. S.E.C. Press Release No. 2007-114 (June 13, 2007), *available at* <http://www.sec.gov/news/press/2007/2007-114.htm>.

75. Rule 10a-1, 17 C.F.R. § 240.10a-1 (2006), *removed and reversed by* Regulation SHO and Rule 10a-1, Exchange Act Release No. 34-55970, 72 Fed. Reg. 36,348 (July 3, 2007).

76. *Id.*

77. Of course, even in a declining market there are upticks (i.e., sales above the last sale price) which give traders opportunities to make short sales, but the tick test limited their ability to force a rapid price decline. For a more detailed description of the short selling rule, *see* LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 865-66 (5th ed. 2004).

78. SEC Press Release No. 2007-114 (June 13, 2007), *available at* <http://www.sec.gov/news/press/207/2007-114.htm>.

79. *Id.* The only academic who sent the SEC a comment on the proposed repeal of the tick test wholeheartedly supported it. *See* James J. Angel, Letter dated Feb. 14, 2007, Associate Professor of Finance at Georgetown University ("Eliminating the rule will remove an expensive compliance headache that produced no benefit for investors.").

regulation,”<sup>80</sup> the Commission decided not only to repeal the rule but also to prohibit any self-regulatory organization (SRO) from adopting or maintaining a tick test of its own.<sup>81</sup> The NYSE, while supporting repeal of the rule, “noted its concern about unrestricted short selling during periods of unusually rapid and large market declines,” which had not happened during the period of the pilot study.<sup>82</sup> The NYSE therefore suggested that SROs be permitted to impose price restrictions on short selling if necessary.<sup>83</sup> The SEC rejected this suggestion and adopted the rule change as originally proposed.<sup>84</sup>

The folly of the SEC’s action was soon made clear. In the market crash of 2008, the conditions that led to adoption of the tick test returned, but without the protection of the rule. According to the head of one securities firm:

Investors have now been whipsawed by what appears to be manipulative trading, what we used to call ‘bear raids,’ which drive stock prices down without warning and at breakneck speed. . . . The SEC has an opportunity to make a real difference in helping to control future market stability and restore confidence in the fairness of our capital markets. But the SEC has been strangely silent as the crisis has worsened.<sup>85</sup>

The financier George Soros was even more critical:

Lehman, AIG and other financial institutions were destroyed by bear raids in which the shorting of stocks and buying of CDS [collateralized debt securities] amplified and reinforced each other. Unlimited shorting was made possible by the 2007 abolition of the uptick rule (which hindered bear raids by allowing short-selling only when prices were rising). The unlimited selling of bonds was facilitated by the CDS market. Together, the two made a lethal combination.<sup>86</sup>

It took the bankruptcy of Lehman, a Wall Street firm founded in 1850, for the SEC to take any remedial action. After announcing a second-quarter loss of \$2.8 billion in June 2008, the firm fought a running battle with short sellers, whom it accused of spreading rumors to drive down the price of the

80. Regulation SHO and Rule 10a-1, Exchange Act Release No. 34-55970, 72 Fed. Reg. 36,348, 36,348 (July 3, 2007).

81. Regulation SHO and Rule 10a-1, Exchange Act Release No. 34-55970, 72 Fed. Reg. 36,348, 36,348.

82. Regulation SHO and Rule 10a-1, Exchange Act Release No. 34-55970, 72 Fed. Reg. 36,348, 36,350.

83. Regulation SHO and Rule 10a-1, Exchange Act Release No. 34-55970, 72 Fed. Reg. 36,348, 36,350.

84. Regulation SHO and Rule 10a-1, Exchange Act Release No. 34-55970, 72 Fed. Reg. 36,348, 36,352.

85. Charles R. Schwab, *Restore the Uptick Rule, Restore Confidence*, WALL ST. J., Dec. 9, 2008, at A17.

86. George Soros, *The Game Changer*, FIN. TIMES, Jan. 29, 2009, at 8.

company's stock.<sup>87</sup> In September 2008, Lehman announced additional huge losses and filed for bankruptcy, a step that is widely thought to have contributed to the crisis of confidence and the freezing of the credit markets, "forcing governments around the globe to take steps to try to calm panicked markets."<sup>88</sup> After Lehman's bankruptcy filing, the SEC banned all short sales in financial stocks, a step that might not have been needed if the tick test had been in place in 2008.<sup>89</sup>

### C. SHAREHOLDER PROXY ACCESS

Because of the widespread ownership of corporate shares, voting of these shares is normally done by proxy.<sup>90</sup> In the "belief that fair corporate suffrage is an important right that should attach to every corporate security bought on a public exchange,"<sup>91</sup> Congress enacted Section 14(a) of the Exchange Act,<sup>92</sup> which authorizes the SEC to adopt rules governing the solicitation of proxies for corporate elections, if in the public interest or for the protection of investors. In 1942, the SEC adopted Rule 14a-8, which, with certain exceptions, permits a shareholder to place a proposal on the proxy ballot that corporate management sends to its shareholders to solicit their votes.<sup>93</sup> Thus, a shareholder who has a proposal that is a proper subject for a shareholder vote can avoid the costly process of printing and distributing the shareholder's own proxy materials.

One of the exceptions in Rule 14a-8 is a shareholder proposal that "relates to an election" for directors.<sup>94</sup> The exception limits access to the proxy with respect to the most significant right that shareholders in a publicly traded company possess: the right to elect the directors.<sup>95</sup> Nevertheless, almost universally, the proxy that management sends to shareholders contains a single slate of directors, and shareholders only have the choice of either voting for management's slate or withholding their votes from one or more of the proposed directors. Rule 14a-8 does not

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87. *Lehman Brothers Holdings, Inc.*, [http://topics.nytimes.com/topics/news/business/companies/lehman\\_brothers\\_holdings\\_inc/index.html](http://topics.nytimes.com/topics/news/business/companies/lehman_brothers_holdings_inc/index.html) (last visited May 19, 2009).

88. *Lehman Brothers Holdings, Inc.*, *supra* note 87.

89. SEC Press Release 2008-218 (Sept. 21, 2008), *available at* <http://www.sec.gov/news/press/2008/2008-218.htm>.

90. *See* LOSS & SELIGMAN, *supra* note 77, at 529-30.

91. *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964) (*quoting* H.R. Rep. No. 1383, 73d Cong., 2d Sess., 13).

92. 15 U.S.C. §78n(a).

93. 17 C.F.R. § 240.14a-8 (2008).

94. 17 C.F.R. § 240.14a-8(i)(8) (2008).

95. ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 111 (2d ed. 2004). Under state law, shareholders have no right to manage the business of a corporation. DEL. GEN. CORP. LAW §141; N.Y. BUS. CORP. LAW §701; *Helfman v. American Light & Traction Co.*, 187 A. 540, 550 (N.J. Ch. 1936) ("In a purely business corporation . . . the authority of the directors in the conduct of the business of the corporation must be regarded as absolute when they act within the law."). Typically, state law requires shareholders to approve major corporate changes, such as mergers and reorganizations.

enable a shareholder to propose a non-management candidate, or slate of candidates, unless the shareholder is willing and able to launch an expensive proxy fight. The typical single-slate election is inconsistent with the “fair corporate suffrage”<sup>96</sup> purpose of Section 14(a).

Although unrestricted shareholder access to the management proxy for the election of directors poses practical problems, with the growth of ownership of corporate shares by institutional investors, it may be feasible to allow limited access. In fact, in 2003, the SEC proposed a rule that would have allowed a shareholder or group of shareholders holding more than five percent of the voting shares to place a nominee on the management’s ballot, but only if the company had been unresponsive to shareholder concerns.<sup>97</sup> Faced with fierce opposition from corporate management, the SEC shelved this relatively mild proposal.

In 2006, an important issue arose concerning the definition of the exception for the election of directors. In *American Federation of State, County & Municipal Employees v. American International Group, Inc. (AIG)*, the Second Circuit held that a shareholder proposal, not to submit a candidate’s name to be voted on for director but simply to amend a company’s bylaws to establish a *procedure* by which shareholder-nominated candidates may be included on management’s ballot, did not “relate to an election” and therefore had to be included in management’s proxy.<sup>98</sup> The court based its decision largely on the inconsistency of previous SEC staff “No Action” letters concerning the exact meaning of the exception.<sup>99</sup>

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96. H.R. Rep. No. 73-1383, at 13 (1934).

97. Security Holder Director Nominations, Exchange Act Release No. 48626, Investment Company Act Release No. 26206, 81 SEC Docket 770 (Oct. 14, 2003).

98. *Am. Fed’n of State, County & Mun. Employees v. Am. Int’l Group, Inc.*, 462 F.3d 121 (2d Cir. 2006).

99. A no action letter is a statement by the staff that it will not take enforcement action if a person engages in certain enumerated acts. Although the staff insists that no action letters are not interpretations of the law, they are universally regarded as such. In the area of shareholder proposals, no action letters allow a company to exclude a given shareholder proposal from its proxy materials.

This was not the first time that a court refused to defer to the views of the SEC on the ground that the SEC previously took a contrary position. In *Int’l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979), the Supreme Court refused to accept the SEC’s position as an *amicus* that a non-contributory pension plan was a security, pointing out that “[u]ntil the instant litigation arose, the public record reveals no evidence that the SEC had ever considered the Securities Acts to be applicable to noncontributory pension plans.” See *Int’l Brotherhood of Teamsters*, at 566. In *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), the District of Columbia Circuit Court of Appeals voided an SEC rule that required a hedge fund manager to register under the Investment Advisers Act of 1940 if the hedge fund had more than 14 investors. The Act requires an adviser to register if it has more than 14 “clients.” The court noted that the SEC had previously taken the position that “when ‘an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of the participants as group, . . . the pool—rather than each participant’ is a ‘client.’” See *Goldstein*, at 880.



In October 2007, the SEC, by a 3–1 vote,<sup>100</sup> broadened the exception to the shareholder proposal rule, thus overruling *AIG*. It amended the rule so as to provide that a shareholder proposal may be excluded if it “relates to a nomination or an election for membership on the company’s board of directors or analogous governing body or a procedure for such nomination or election.”<sup>101</sup> Although the Commission claimed that the amendment was merely intended to clarify the “election of directors” exclusion, its effect has been a substantial diminution of shareholder rights.

As a result of the rule change, shareholders have neither the right to place their nominees on management’s ballot, nor the right to alter the voting system to give themselves greater access to the proxy process. Coming down firmly in favor of management and against public shareholders, the SEC stated that management may exclude shareholder proposals “requiring companies to include shareholder nominees for director . . . or otherwise resulting in a solicitation on behalf of shareholder nominees in opposition to management-chosen nominees.”<sup>102</sup>

#### D. OPPOSITION TO PRIVATE LAWSUITS

The SEC has repeatedly urged the Supreme Court to reduce the rights of investors in private lawsuits seeking recovery for securities fraud. In *amicus curiae* briefs, the SEC has used its influence to persuade the Court to require mandatory arbitration of customer-broker disputes, to give investment bankers immunity from antitrust liability, to tighten pleading requirements in securities fraud cases, and to dismiss investors’ claims on the ground of failure to prove causation. Furthermore, in one landmark case,<sup>103</sup> several former SEC commissioners, some of whom represented companies with an actual or potential interest in the litigation, filed an *amicus* brief opposed to the interests of investors.

SEC *amicus curiae* briefs have been influential in shaping the views of the Court on the complex issues it often faces in securities cases. In earlier years, the SEC used these briefs to support plaintiff investors, arguing that enforcement of the securities laws by investors is “a necessary supplement to Commission action.”<sup>104</sup> In *Bateman Eichler, Hill Richards, Inc. v. Berner*,<sup>105</sup> a 1985 securities fraud case involving the false “tipping” of non-existent inside information, the Court expressly referred to the SEC’s

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100. The vote was along party lines, the Republicans on the Commission voting in favor of the rule and the Democrats voting against. One Democratic seat was vacant at the time. Bryn R. Vaaler, *SEC Permits Exclusion of Shareholder-Access Proposals*, DORSEY & WHITNEY LLP, Nov. 28, 2007, available at [http://www.dorsey.com/corporate\\_update\\_nov28\\_2007/](http://www.dorsey.com/corporate_update_nov28_2007/).

101. Shareholder Proposals Relating to the Election of Directors, Exchange Act Release No. 56914, SEC Docket 256 (Dec. 6, 2007).

102. *Id.*

103. *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761 (2008).

104. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

105. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985).

*amicus* brief supporting the plaintiff, stating: “The SEC has advised us that it ‘does not have the resources to police the industry sufficiently to ensure that false tipping does not occur or is consistently discovered’ . . . . Thus it is particularly important to permit ‘litigation among guilty parties.’”<sup>106</sup> The SEC itself echoed this view in 1994 when it filed an *amicus* brief for the plaintiff with the Court in *Central Bank of Denver v. First Interstate Bank of Denver*: “Private actions under Rule 10b-5 are an essential supplement to Commission enforcement of the Exchange Act, and the Commission has a strong interest in seeing that the principles applied in such actions promote the purposes of the securities laws.”<sup>107</sup>

Nevertheless, in recent years the Commission filed several *amicus* briefs in private securities suits urging the Court to interpret the securities laws narrowly and in contravention of investors’ interests. In *Shearson/American Express, Inc. v. McMahon*, the issue before the Court was whether an agreement between a customer and a brokerage firm to arbitrate any future dispute that might arise under the Exchange Act was enforceable.<sup>108</sup> The SEC’s *amicus* brief argued that the section of the Exchange Act that voids a waiver of compliance with any provision of the Exchange Act or SEC rules did not apply to a waiver of the right to have a dispute tried in a federal court, but only to substantive rights.<sup>109</sup> The securities industry wanted mandatory arbitration of disputes with its customers because: (1) arbitration tends to be less expensive than litigation and (2) it believed that a panel selected in an industry-sponsored arbitration would be less likely than a federal jury to favor the investor. Mandatory arbitration could not have benefited investors, because the rules of the NYSE and NASD already required their members to arbitrate any customer dispute if the customer so desired. The Supreme Court held, by a 5–4 vote, that the arbitration agreement, which was on a standard printed form given to the customer to sign on a take-it-or-leave-it basis, was enforceable.<sup>110</sup> The SEC’s brief may well have had a strong, if not decisive, influence on the Court’s decision.

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106. *Id.* at 315–16.

107. *See* Brief for the Securities and Exchange Commission as Amicus Curiae in Support of Respondents at 2, *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (No. 92-854) (the Court disagreed with the SEC and held for the defendant).

108. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 222 (1987).

109. The anti-waiver provision is §29(a) of the Exchange Act. *See* 15 U.S.C. § 29(a) (2006). In *Wilko v. Swan*, 346 U.S. 427 (1953), the Supreme Court had held that an agreement to arbitrate a dispute arising under the 1933 Act was unenforceable, citing the anti-waiver provision of that Act and concluding that the investor-protection purposes of the securities laws trumped the purpose of the Federal Arbitration Act, which was to enforce agreements to arbitrate to the same extent as other contracts. Since *McMahon* involved the anti-waiver clause of the Exchange Act, not the Securities Act, it did not overrule *Wilko*, but two years later the Court formally overruled *Wilko* in *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989).

110. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 242 (1987). The arbitration clause was in a standard-form contract. *See id.*, Exhibit to the Record at 2541, 1853.

The SEC's anti-investor stance in *McMahon* was unusual at the time, but during recent years the Commission has consistently filed, or participated in filing, *amicus* briefs with the Supreme Court on behalf of defendants in securities cases.

In *Dura Pharmaceuticals, Inc. v. Broudo*,<sup>111</sup> the question before the Court was what was necessary in order for a plaintiff to plead the requisite element of "loss causation" (i.e., that the defendant's securities fraud caused the harm to the plaintiff) in a Rule 10b-5 suit. The suit was a class action, in which plaintiffs claimed that misrepresentations by the defendant corporation had led them to buy shares in the corporation. The Court, at the urging of the SEC, interpreted the loss causation requirement strictly. It held that a misrepresentation claim must be dismissed if it fails to allege that the defendant's misrepresentations caused a disparity between the market price and the value of the stock *at the time the plaintiffs bought the stock*, even though the plaintiffs later sold the stock for a loss at a lower price.<sup>112</sup> Yet, before a trial of the issues, it may be impossible for a plaintiff to allege sufficient facts to plead loss causation. The *Dura* decision has greatly increased the difficulty for plaintiffs in securities fraud suits to get past the pleading stage and have their cases heard by a jury.<sup>113</sup>

In *Tellabs v. Makor Issues & Rights, Ltd.*,<sup>114</sup> the Court, reversing the Seventh Circuit, strictly interpreted the Private Securities Litigation Reform Act of 1995 (PSLRA) provision that required a plaintiff in a securities fraud suit to plead "with particularity facts giving rise to a strong inference of" the defendant's scienter (scienter, i.e. intentional or reckless conduct, is a requisite element of a Rule 10b-5 claim).<sup>115</sup> The Court held that, in order to decide whether to dismiss a complaint for failure to meet this requirement, the trial court must weigh all reasonable competing inferences, including those potentially negative to the plaintiff.<sup>116</sup> Thus, the judge, before trial, must assume the role that a jury would normally perform, and dismiss the case if inferences negative to the plaintiff outweigh those that are positive to him. The government's brief, which was signed by members of the SEC's Office of General Counsel, supported this anti-investor interpretation of the PSLRA.<sup>117</sup> Like the *Dura* decision, *Tellabs* restricts the ability of plaintiffs in securities fraud suits to get beyond the pleading stage and have their cases tried by a jury.

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111. *Dura Pharmaceuticals, Inc. v. Michael Broudo*, 544 U.S. 336 (2005).

112. *Id.*

113. *See, e.g., McCabe v. Ernst & Young, LLP*, 494 F.3d 418 (3d Cir. 2007); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005).

114. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

115. 15 U.S.C. § 78u-4.

116. *Tellabs, Inc.*, at 308.

117. Brief for the United States as Amicus Curiae Supporting Petitioners, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) (No. 06-484).

In *Credit Suisse Securities (USA) LLC v. Billing*,<sup>118</sup> the issue was whether investment banking firms that engage in anti-competitive practices in connection with initial public offerings (IPOs) of securities enjoy an implied immunity from liability under the antitrust laws. In earlier cases, the Supreme Court had been reluctant to imply immunity from antitrust liability on the ground that the actions complained of were governed by another federal regulatory scheme. The Court had held that such immunity exists only where anticompetitive actions in the securities area are necessary to make the Exchange Act work, and even then only to the extent necessary.<sup>119</sup> In *Billing*, the practices complained of in the antitrust suit were alleged misconduct in IPOs that the SEC either had previously condemned or, in all likelihood, would not approve in the future.<sup>120</sup> In response to a request by the Court, the SEC's General Counsel gave an opinion that there was implied immunity from the antitrust laws.<sup>121</sup> The Supreme Court, reversing the Second Circuit, agreed with the SEC on the grounds that the case involved "(1) an area of conduct squarely within the heartland of securities regulations; (2) clear and adequate SEC authority to regulate; (3) active and ongoing agency regulation; and (4) a serious conflict between the antitrust and regulatory regimes."<sup>122</sup> The *Billing* decision broadened the scope of antitrust immunity beyond that established in previous Supreme Court cases and further limited investors' ability to recover for harm done to them by brokerage firms.

The Supreme Court decision of recent years that, from a practical viewpoint, probably most restricted the ability of investors to recover damages from securities fraud was *Stoneridge Partners, LLC v. Scientific-Atlanta, Inc.*<sup>123</sup> In 1994, the Supreme Court held in *Central Bank of Denver, v. First Bank of Denver*, that a private plaintiff could not maintain a suit against a person for aiding and abetting a violation of Rule 10b-5, but could only sue primary violators of the rule.<sup>124</sup> The question raised in *Stoneridge* was whether persons who knowingly participated in a fraudulent scheme, but made no acts or statements that the plaintiff relied on, could be regarded as primary violators (and therefore subject to possible liability under Rule 10b-5) or only as aiders and abettors. The case was of the utmost importance because the decision was likely to affect the liability of the only persons from whom victims of massive corporate frauds such as Enron and WorldCom might recover their losses: secondary actors such as accountants, attorneys, and investment bankers.

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118. *Credit Suisse Securities (USA) v. Glen Billing*, 127 S.Ct. 2383 (2007).

119. *Silver v. New York Stock Exch.*, 373 U.S. 341, 357 (1963).

120. These practices are described below in text accompanying notes 148–51.

121. Letter Brief, at 7, *Credit Suisse Securities (USA) v. Billing*, 551 U.S. 264 (2007) (Nos. 03-9284 and 03-9288).

122. *Credit Suisse Securities*, 127 S.Ct. at 2397.

123. *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761 (2008).

124. *Central Bank of Denver v. First Bank of Denver*, 511 U.S. 164, 191 (1994).

The SEC did not file an *amicus* brief in *Stoneridge*, but a group of sixteen former SEC chairmen, commissioners, and general counsels, as well as eleven law professors, did file a brief arguing that secondary actors could not be primary violators of Rule 10b-5 unless they themselves made false statements on which the plaintiffs relied.<sup>125</sup> In particular, the brief urged the Court to reject the plaintiffs' theory of "scheme liability": that a secondary actor who knowingly participates in a fraudulent scheme may be liable under Rule 10b-5 even if that person does not himself make a false public statement.<sup>126</sup> The brief went further, arguing that to adopt the scheme liability theory would expand the right of action under Rule 10b-5, and that "[t]he days of judicially-implied private rights of action are long past."<sup>127</sup> The Court, affirming a decision of the Eighth Circuit by a 5–3 vote, adopted much of the reasoning in the *amicus* brief and held in favor of the defendants.

The filing of this strongly anti-investor brief by a large group of former SEC chairmen and commissioners is a matter of some concern. For one thing, it indicates the extent to which *laissez-faire* "law and economics" theory has influenced academics and even regulators. Even so, it is surprising that a large number of former members and senior officials of the SEC should go out of their way to obtain a narrow interpretation of the Exchange Act that would defeat or hinder investors' chances of recovery of losses due to securities fraud.

It is possible that the signers of the brief were deluded by anti-regulatory theory, but it is also possible that at least some of the signers were serving their own financial interests. What is most disturbing is that their brief did not disclose any of their existing affiliations or clients; they identified themselves only by their former positions at the SEC, which was

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125. The former SEC chairmen who signed the brief were Roderick M. Hills, Harvey L. Pitt (who had previously been General Counsel), and Harold M. Williams. The former commissioners were Charles C. Cox, Edward H. Fleischman, Stephen J. Friedman, Joseph A. Grundfest, Isaac C. Hunt, Jr., Roberta S. Karmel, Philip R. Lochner, Jr., Richard Y. Roberts, Laura S. Unger, and Steven Wallman. The former general counsels (in addition to Pitt) were James Doty and Simon M. Lorne. Brief for Former SEC Commissioners et al. as Amici Curiae Supporting Respondents at 2–3, 24, *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2007) (No. 06-43). Former chairmen William H. Donaldson and Arthur Levitt and former commissioner Harvey Goldschmid (who had previously served as General Counsel) filed an *amicus* brief on behalf of the plaintiff. *See id.*

126. Brief for Former SEC Commissioners and Officials and Law and Finance Professors as Amici Curiae Supporting Respondents, at 15–16, *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761 (2007) (No. 06-43).

127. Brief for Former SEC Commissioners et al. as Amici Curiae Supporting Respondents at 24, *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2007) (No. 06-43). The question of whether there was an implied right of action for a violation Rule 10b-5 was not even before the Court, which had acknowledged that such a right existed on several previous occasions. *See, e.g., Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983) ("[A] private right of action under Section 10(b) of the 1934 Act and Rule 10b-5 has been consistently recognized for more than 35 years. The existence of this implied remedy is simply beyond peradventure."). *See also Superintendent of Ins. v. Bankers Life and Cas. Co.*, 404 U.S. 6 (1971).

the only reason their views would have had any significance to the Court. Several signers were partners in Washington law firms or consulting firms that represented publicly-held corporations, banks and broker-dealers—entities that may well have had a potential financial interest in the outcome of the case.<sup>128</sup> One of the signers was a partner in a law firm that advertised itself as a Washington lobbyist for corporate clients.<sup>129</sup>

The “revolving door” practice, under which SEC staff members may be tempted to “go easy” on enforcing securities laws because they have the prospect of high-paying Wall Street jobs, has been widely commented on (and will be discussed below), particularly in connection with the recent SEC enforcement failures.<sup>130</sup> However, the potential evils of the revolving door also implicate members of the Commission. For a substantial number of these persons to use their prestige, acquired at least in part from their former positions as members (or general counsels) of the SEC, to urge the Supreme Court to interpret the securities laws in favor of their clients (and not in favor of investors), without any disclosure of their affiliations or the identity of their clients, is a measure of the distance that the SEC has traveled from its original mission of investor protection. It does not seem rash to predict that present members of the Commission will, after they reenter private life, similarly use their former positions to serve their corporate clients to the detriment of public investors.

### III. ENFORCEMENT FAILURES

The Bernard Madoff scandal that came to light in December 2008 was only the latest of the SEC’s enforcement failures during the past decade. Unlike Madoff’s Ponzi scheme, which apparently was a single huge fraud, many of the other situations involved abuses that were widespread in the securities industry. Since 2000, the SEC has failed to take timely and effective action to prevent abuses in connection with IPOs, tainted investment advice by research analysts at investment banking firms, late trading and market timing of mutual funds, and fraudulent sales of auction

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128. Edward H. Fleischman, a former commissioner, was counsel to Linklaters LP, a law firm that represents banks and investment companies, and specializes in advice to the world’s leading companies; Harvey L. Pitt, a former chairman, was the CEO of Kalorama Partners, LLC, a consultant to corporations; Steven Wallman, a former commissioner, was founder of FOLIOfn, a brokerage and investment company; Roderick M. Hills, a former chairman, was a founder and partner of Hills, Stern & Morley, a law firm that represents international finance corporations; James Doty, a former general counsel, was a partner in Baker Botts, a law firm that represents corporations and broker-dealers; Simon M. Lorne, a former general counsel, was vice chairman and chief legal officer of Millenium Management LLC, a hedge fund.

129. Richard Y. Roberts, a former commissioner, was a partner in Roberts, Raheb & Gradler, a law firm that advertises itself as a lobbyist for corporate clientele.

130. See, e.g., Paul Krugman, *The Madoff Economy*, N.Y. TIMES, Dec. 19, 2008, at A45.

rate securities. Investors have lost billions of dollars as a result of the SEC's inability or unwillingness to fulfill its enforcement responsibilities.<sup>131</sup>

Ironically, in its own enforcement activities, the SEC has not met the standard of conduct that it requires of the broker-dealer firms it regulates.<sup>132</sup> On numerous occasions, the SEC has failed to detect abuses or has failed to take appropriate action despite the appearance of "red flags," where similar conduct by a broker-dealer firm would have invited SEC disciplinary action. When imposing sanctions on brokerage firms for inadequate supervision, the SEC has stated:

We have repeatedly held that brokers and dealers are under a duty to supervise the actions of employees and that in large organizations it is especially imperative that the system of internal control be adequate and effective *and that those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention.*<sup>133</sup>

There must be adequate follow-up and review when a firm's own procedures detect irregularities or unusual trading activity . . . .<sup>134</sup>

It appears that, far from monitoring the securities markets and securities industry in order to detect and terminate abusive and illegal practices, the SEC was prompted into action only after investigative financial reporters or state regulators had unearthed them. Congressional and internal investigations of SEC enforcement policies and procedures, prompted in part by the sensational Madoff case, may determine whether the Commission's failure to enforce the securities law was a result of policy or ineffectiveness, or a combination of the two. In either case, the sheer number and size of its failures point to a systemic problem at the agency.

#### A. ABUSES IN IPOS

In 2000, several industry-wide abuses by investment banking firms in the allocation of new issues of securities were exposed, largely through the work of investigative reporters at the Wall Street Journal (Journal). In the "hot issue" market of the late 1990s, obtaining an allocation of a new issue

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131. This partial listing of SEC enforcement failures does not include its failure to prevent widespread violations of law for protracted periods in the nation's two principal stock markets. At the NYSE, between 1999 and 2006, all seven specialist firms denied investors the best prices by needlessly interpositioning themselves between public orders for their own profit. In the Nasdaq over-the-counter market, traders routinely rigged prices for several years during the 1990s. POSER & FANTO, *supra* note 45, at §4.01[D], 9–11.

132. Exch. Act §15(b)(4)(E) gives the SEC authority to impose disciplinary sanctions on broker-dealers that fail to exercise reasonable supervision over their personnel.

133. Reynolds & Co., Exchange Release No. 6273, 39 SEC 902, 917, 1960 WL 56264 (May 25, 1960) (emphasis added). *See also* John H. Gutfreund, Exch. Act Release No. 31554, 1992 WL 362753 (Dec. 3, 1992).

134. Smith Barney, Harris Upham & Co., Exch. Act Release No. 21813, 1985 WL 548567, at \*7 (Mar. 5, 1985).

was extremely valuable. It was not uncommon for the price of a newly issued stock to rise by more than fifty percent during the first day of trading. In January 2000, the Journal reported that several Wall Street firms kept secret lists of institutional investors to whom the firms awarded new issue allocations in return for their brokerage business.<sup>135</sup> Thus, even though an offering was ostensibly made to the public, a large proportion of the shares went to favored customers in return for a valuable consideration.

Later that year and in 2001, the Journal published additional information about widespread abuses in the allocation process. They included: (1) “spinning,” i.e., allocating IPO stocks to the personal accounts of executives of companies in return for the companies’ investment banking business;<sup>136</sup> (2) “laddering,” i.e., allocating IPO shares of a company on condition that the client buys additional shares of the company’s stock in the aftermarket;<sup>137</sup> and (3) allocating IPO shares on condition that the client pay especially high commissions on unrelated brokerage transactions.<sup>138</sup> According to the SEC staff, laddering was an illegal manipulative device.<sup>139</sup> Spinning and charging excessive commissions may also have amounted to illegal kickbacks.<sup>140</sup> The effect of these practices was not only to manipulate the after-market prices of new issues but also to exclude the ordinary individual investor, who had nothing to offer the underwriter except ordinary commissions on his or her transactions, from allocations of public offerings of securities.

In late 2000, the Journal reported that, according to a former SEC commissioner, the agency had discussed various questionable practices in the allocation of IPOs in the early 1990s, but it was not until 1997 that SEC

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135. Randall Smith & Suzanne McGee, *Major Institutions, Led by Fidelity, Get Most of Hot IPOs, Lists Show*, WALL ST. J., Jan. 27, 2000 at C1.

136. Terzah Ewing, *NASD Would Bar Some Big Investors From All IPOs, Not Just the Hot Ones*, WALL ST. J., Aug. 18 2000, at B2; Charles Gasparino et al., *SEC Targets IPO Process With Probes — Latest Case Poses Challenge for Agency, But Solutions Exist*, WALL ST. J., Dec 19, 2000 at C1.

137. Susan Pulliam et al., *Coming to Terms: CSFB Agrees to Pay \$100 Million to Settle Twin IPO Investigations — Probes by SEC and NASD Grew Out of Conduct During Dot-Com Frenzy — A Legacy of Wheat’s Reign*, WALL ST. J., Dec 11, 2001, at A1; Cassell Bryan-Low, *Deals & Deal Makers: Latest IPO Boom: Number of Suits Alleging Abuses by Underwriters*, WALL ST. J., Nov. 29, 2001, at C12; Susan Pulliam & Randall Smith, *SEC’s IPO Inquiries Advance on Two Fronts*, WALL ST. J., Nov. 28, 2001, at C1.

138. Gasparino et al., *supra* note 136, at C1; Kathryn Kranhold, *Deals & Deal Makers: SEC Intensifies Inquiry Into Commissions for Hot IPOs — Are Hefty Payments Business as Usual — Or Illegal Activity*, WALL ST. J., Dec. 13, 2000, at C1; Randall Smith & Susan Pulliam, *U.S. Probes Inflated Commissions for Hot IPOs*, WALL ST. J., Dec. 7, 2000, at C1.

139. In August 2000, the SEC staff opined that laddering (a device designed to ensure a continued rise in the price of the stock) was a violation of the SEC’s anti-manipulative rules. SEC Staff Legal Bulletin No. 10 (Aug. 25, 2000).

140. These practices were the basis for the investors’ claims in the *Billing* antitrust case, discussed above. They were also the subject of over 1,000 securities class actions brought by investors, which were consolidated in the U.S. District Court for the Southern District of New York. *See In re Initial Public Offering Sec. Litig.*, 294 F.3d 297 (2d Cir. 2002).



enforcement officers began investigating possible spinning.<sup>141</sup> “After the Journal’s ‘spinning’ disclosures, . . . the SEC’s enforcement division . . . launched full-blown investigations into the matter.”<sup>142</sup> Thus, throughout the 1990s, major investment banking firms were engaged in abusive practices without any intervention by the SEC, although the SEC had received warnings of those practices years earlier.

## B. RESEARCH ANALYSTS

On April 8, 2002, New York Attorney General (NYAG) Eliot Spitzer announced the results of an investigation of conflicts of interest of research analysts at Merrill.<sup>143</sup> The investigation showed that, from 1999 to 2001, Merrill did not publish a single “reduce” or “sell” recommendation on any stock in its Internet group. Furthermore, internal Merrill emails by analysts referred to some stocks that the firm was recommending to its customers as a “piece of junk,” a “piece of crap,” or in even more disparaging language.<sup>144</sup> The NYAG discovered that, unknown to the general public, Merrill’s research analysts were not giving impartial investment advice to their customers, rather, the advice was tailored to attract and keep the investment banking business of corporate clients.

Two weeks after the NYAG’s announcement, the SEC announced that it was making an inquiry into the practices of research analysts at Merrill.<sup>145</sup> Eventually, it became clear that the conflicts of interest of Merrill’s analysts were far from unique; the problem pervaded the securities industry. In April 2003, the SEC, NYSE, NASD, NYAG, and several other state securities regulators announced the details of a “global settlement” with ten of the largest investment banking firms and two individual analysts.<sup>146</sup> The settlement with the firms included monetary relief of \$1.4 billion, including civil penalties and disgorgement of profits, as well as various procedural reforms.<sup>147</sup>

It does not appear that the SEC took any action in the research analyst scandal until the NYAG’s sensational announcement prompted it to act.<sup>148</sup> For at least two years, the largest broker-dealer firms made a practice of betraying their customers by publishing tainted research reports, apparently without the SEC noticing.

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141. Gasparino et al., *supra* note 136, at C1.

142. *Id.*

143. POSER & FANTO, *supra* note 45, §22.04[B], at 26–29, §22.04[C], at 30–34, §22.04[D], at 34–38, §22.04[E], at 38–40, §22.04[F], at 40.

144. *Id.* at §22.04[B], at 22–27, §22.04[C].

145. SEC Launches Inquiry into Research Analyst Conflicts, Release No. 2002-56 (Apr. 25, 2002).

146. POSER & FANTO, *supra* note 45, at §22.04[C], at 30–34.

147. *Id.* at §22.04[C], at 22–30.

148. *Id.* at §22.04[B], at 26–29, §22.04[C], at 30–34, §22.04[D], at 34–38, §22.04[E], at 38–40, §22.04[F], at 40.

### C. LATE TRADING AND MARKET TIMING

In September 2003, NYAG Spitzer announced that his office had obtained evidence of “widespread illegal trading schemes that potentially cost mutual fund shareholders billions of dollars.”<sup>149</sup> These schemes consisted of “late trading” and “market timing” of mutual funds.<sup>150</sup> The NYAG simultaneously announced that it had reached a \$40 million settlement with a hedge fund and its managing principal on charges involving these abuses.<sup>151</sup>

Late trading is a violation of SEC Rule 22c-1 under the Investment Company Act of 1940, which requires “forward pricing” of mutual fund shares.<sup>152</sup> Forward pricing means that the purchaser (or seller) of a mutual fund pays (or receives) a price that is based on the net asset value of the fund at the close of the market (4:00 p.m. Eastern Time) following the purchase.<sup>153</sup> Late trading involves the purchase or sale of fund shares after the market closes, at a price that has already been set, allowing the trader to take advantage of post-closing events that are not reflected in the net asset value of the fund.<sup>154</sup> According to the NYAG, “[a]llowing late trading is like allowing betting on a horse race after the horses have crossed the finish line.”<sup>155</sup>

Market timing involves short-term trading of mutual fund shares. Additionally, in the case of funds that invest in foreign shares, it may be used to take advantage of time-zone differences. The practice is not illegal; in fact, the SEC staff had earlier been opposed to restricting short-term trading in mutual funds because the restriction would have limited investors’ right to redeem their shares; as a result, in 2000, the SEC did not take a position when some market timers sued fund companies for trying to restrict their trading.<sup>156</sup> Nonetheless, a mutual fund prospectus that states that the fund does not permit short-term trading may be misleading if the fund company does permit certain traders to trade short-term. Furthermore, a broker-dealer or investor who falsifies his or her identity to engage in trading not permitted by the fund company may be committing fraud.<sup>157</sup>

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149. Press Release, N.Y. Attorney General, Attorney General Spitzer and Securities and Exchange Commission File Charges Against Bank of America Broker (Sept. 2003) [hereinafter Sept. 2003 Press Release, Attorney General Spitzer].

150. *Id.*

151. *Id.* The announcement of the settlement stated that the hedge fund and its managers agreed to make restitution of \$30 million in illegal profits and pay a \$10 million penalty.

152. 17 C.F.R. § 270.22c-1 (2009).

153. *Id.*

154. Marcia Vickers, *How Eliot Spitzer Makes the SEC Look Stodgy*, BUS. WK., Sept. 15, 2003, available at [http://www.businessweek.com/magazine/content/03\\_37/b3849047.htm](http://www.businessweek.com/magazine/content/03_37/b3849047.htm).

155. Sept. 2003 Press Release, Attorney General Spitzer, *supra* note 149.

156. This information was given to the author by David Silver, a former president of the Investment Company Institute, the trade association of the mutual fund industry.

157. *In re Mutual Funds Inv. Litig.*, 384 F.Supp.2d 845 (D. Md. 2005).

Subsequent investigations by the NYAG and the SEC revealed that several hedge funds and other investors, assisted by brokerage firms and, in some cases, by mutual fund companies, had engaged in late trading and market timing for years. Nevertheless, despite the fact that the SEC made regular examinations of mutual fund companies during the period in question, it never brought an enforcement action against any broker-dealer, mutual fund company, hedge fund, or any other investor based on either of these practices before the NYAG's announcement in September 2003.

#### D. AUCTION RATE SECURITIES (ARS)

ARS are long-term bonds or preferred stock whose interest rates or dividends are reset by auctions that typically occur at intervals of between seven and thirty-five days. These auctions provide the primary source of liquidity for investors who wish to sell their investments. Investors who buy ARS typically seek a cash-like investment that pays a higher yield than a money market fund or certificate of deposit.<sup>158</sup>

During recent years, billions of dollars of ARS were sold to investors by major brokerage houses as cash alternatives. In February 2008, the ARS market collapsed, with the result that investors were left holding illiquid securities.<sup>159</sup> In June 2008, William F. Galvin, Secretary of the Commonwealth of Massachusetts, brought a civil action against UBS Securities, LLC and UBS Financial Services, Inc. (together, UBS), charging that UBS had sold ARS to customers with false representations that they were liquid, safe, money-market instruments that could be sold at the next auction, whereas "no true auction existed for many of these securities."<sup>160</sup> A month later, NYAG Andrew Cuomo announced his own lawsuit against UBS, charging that "UBS customers are holding more than \$25 billion in illiquid, long-term paper as a result of UBS's fraudulent misrepresentations and illegal conduct."<sup>161</sup> On July 31, the Massachusetts regulator, Secretary of the Commonwealth William Galvin, brought a similar action against Merrill;<sup>162</sup> and on August 7, the NYAG announced a settlement with Citigroup under which the company would fully reimburse 40,000 customers who had been unable to sell their ARS since February 12, 2008, and pay civil penalties of \$50 million each to the NYAG and the North

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158. FINRA Investor Alert, Auction Rate Securities: What Happens When Auctions Fail, <http://www.finra.org/investors/ProtectYourself/InvestorAlerts/Bonds/PO38207> (last visited Feb. 4, 2009).

159. *Id.*

160. Administrative Complaint, *In the Matter of UBS Securities, LLC & UBS Financial Services, Inc.*, Office of the Secretary of the Commonwealth of Mass., No. 2008-0058 (June 26, 2008).

161. Press Release, N.Y. Attorney General, Attorney General Cuomo brings National Multi-Billion Dollar Lawsuit Against UBS for Auction Rate Securities Scandal (July 24, 2008).

162. Administrative Complaint, *In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Office of the Secretary of the Commonwealth of Mass., No. 2008-0058 (July 31, 2008).

American Securities Administrators Association (NASAA).<sup>163</sup> On August 11, the NYAG announced that it was expanding its investigation to JPMorgan Chase, Morgan Stanley, and Wachovia.<sup>164</sup>

Until August 7, 2008, the SEC took no public action with respect to the ARS mess. However, on that day, the SEC enforcement chief announced a preliminary settlement with Citigroup compatible with the agreements already reached with the NYAG and NASAA.<sup>165</sup> It is disturbing enough that:

where hundreds of thousands of ordinary investors were stuffed with impossible-to-sell bonds they thought were the equivalent of cash – it has been Andrew Cuomo, the combative attorney-general of New York State, who has wrung restitution out of brokers thanks to his legal threats, rather than the SEC.<sup>166</sup>

It is at least equally disturbing that, before the ARS market collapsed in February 2008, several of the largest brokerage firms were selling many billions of dollars of securities to their customers throughout the country by means of misrepresentations as to the nature of these securities, while the SEC was either unaware of this practice or, if it was aware, took no action to stop it.

#### **E. THE MADOFF SCANDAL**

On December 11, 2008, the SEC charged Bernard Madoff and his investment firm, Bernard L. Madoff Investment Securities LLC, with perpetrating a multi-billion dollar Ponzi scheme on advisory clients of the firm.<sup>167</sup> In view of the fact that the SEC had apparently not detected four previous industry-wide multi-billion dollar frauds during the past eight years until the frauds were pointed out to it by state regulators or the financial press, it does not seem surprising that the Commission missed this one. In the Madoff case, the SEC ignored repeated warnings and filed a complaint in federal court only after Madoff's own sons turned him in and he voluntarily admitted to the SEC staff that his investment advisory business was "all just one big lie . . . basically a giant Ponzi scheme."<sup>168</sup>

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163. Press Release, N.Y. Attorney Gen., Attorney General Cuomo Announces Landmark Settlement with Citigroup to Recover Billions in Auction Rate Securities for Investors Nationwide (Aug. 7, 2008).

164. Press Release, N.Y. Attorney Gen., Attorney General Cuomo Expands Investigation into Auction Rate Securities Scandal (Aug. 11, 2008).

165. Speech by SEC Staff: Statement at News Conference Announcing Citigroup Preliminary Settlement (Aug. 7, 2008).

166. Stephen Foley, *How Wall Street's Watchdog May Be Muzzled*, THE INDEPENDENT (London), Aug. 15, 2008.

167. Press Release, *SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme*, Release No. 2008-293 (Dec. 11, 2008).

168. *Id.*

According to the SEC, Madoff estimated that the losses from his fraud were at least \$50 billion.<sup>169</sup>

What was surprising was SEC Chairman Christopher Cox's reaction to the Commission's failure. He publicly attacked the SEC staff. A former SEC Special Counsel described the attack as "throwing the agency's enforcement staff 'under the bus' to deflect blame for his own leadership failures."<sup>170</sup> Five days after announcing the charges against Madoff, Chairman Cox issued a press release:

Our initial findings have been deeply troubling. The Commission has learned that credible and specific allegations regarding Mr. Madoff's financial wrongdoing, going back to at least 1999, were repeatedly brought to the attention of SEC staff, but were never recommended to the Commission for action. I am gravely concerned by the apparent multiple failures over at least a decade to thoroughly investigate these allegations or at any point to seek formal authority to pursue them.<sup>171</sup>

Nowhere in the press release was there any suggestion that the Commission itself might have been at fault or that the Chairman and the four other Commissioners bore some responsibility for what had gone wrong. Again, it may be helpful to analogize the Commission's responsibility to supervise its staff to the obligation that the SEC places on the senior management of brokerage firms. According to the SEC in one enforcement action: "[R]esponsibility for the supervisory function of a registered broker-dealer is incumbent upon the most senior members of management. Senior management has a duty not only to provide a meaningful supervisory structure, but also to actively monitor and enforce it."<sup>172</sup> In another such case, the SEC stated: "Establishment of policies and

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169. *Id.* See also Joanna Chung, *Prosecutor Reveals \$1m Details of Madoff's Jewellery Mailing List*, FIN. TIMES, Jan. 8, 2009, at 1 ("Mr. Madoff's sons alerted prosecutors last week that they had received jewellery in the mail from their father. Mr. Madoff's alleged fraud came to light last month when they turned him in.").

170. Joanna Chung & Greg Farrell, *SEC Under Pressure on Failed Detection*, FIN. TIMES, Dec. 18, 2008, at 16.

171. Press Release, SEC, Statement Regarding Madoff Investigation 2008-297 (Dec. 16, 2008). According to one report in the financial press, the SEC's investigatory interest in Madoff goes back to at least 1992, as the result of a confidential tip that three small firms raising money exclusively for Madoff were promising annual returns of up to 20 percent. The SEC shut down the firms for selling unregistered shares, but the investigation raised no red flags as to Madoff's operations. Peter Burrows, *How Madoff is Burning the SEC*, BUS. WK., Jan. 12, 2009, (Magazine), at 24, available at [http://www.businessweek.com/magazine/content/09\\_02/b4115024163467.htm?chan=magazine+channel\\_news](http://www.businessweek.com/magazine/content/09_02/b4115024163467.htm?chan=magazine+channel_news). In January 2009, the SEC's inspector general told a congressional committee that his office had begun an investigation into the agency's failure to uncover the alleged Ponzi scheme. Alex Berenson, *Bid to Revoke Madoff's Bail Cites His Gifts*, N.Y. TIMES, Jan. 6, 2009, available at [http://www.nytimes.com/2009/01/06/business/06madoff.html?\\_r=1&partner=MOREOVERNEWS&ei=5040](http://www.nytimes.com/2009/01/06/business/06madoff.html?_r=1&partner=MOREOVERNEWS&ei=5040).

172. Signal Sec., Inc., Exchange Act Release No. 43350, 2000 WL 1423891, at \*8 (Sept. 26, 2000). Exchange Act § 15(b)(4)(E) expressly imposes on broker-dealer firms a duty to supervise,

procedures alone is not sufficient to discharge supervisory responsibility. It is also necessary to implement measures to monitor compliance with those policies and procedures.”<sup>173</sup>

Furthermore, the SEC has emphasized the importance of a broker-dealer firm making internal audits of its branch offices and then acting on any potential or actual problems identified in the audit reports.<sup>174</sup> The fact that the SEC’s enforcement staff had failed to uncover several massive frauds in the recent past should have made it clear to the Commission that it needed a supervisory program to monitor its examiners and investigators to make sure they were doing their job, including to determine whether the Commission was alerted to red flags indicating possible misconduct.<sup>175</sup> If the SEC had itself followed the precepts that it laid down for broker-dealers, it might have detected the Madoff fraud many years earlier and saved investors billions of dollars of losses.

#### IV. WHY THE SEC FAILED

##### A. REGULATORS AGAINST REGULATION

The financial debacle of 2008 and the Madoff scandal have generated criticism of the SEC’s performance and several explanations for the agency’s failures. The explanations include conflicts of interest of the staff, lack of staff training, budgetary restraints, and the fragmented nature of the regulatory system. The fundamental reason for the failures, however, is the anti-regulatory climate, supported by academically generated anti-regulatory theory, that has pervaded government (including the SEC) in the past two or three decades. The SEC’s main focus has changed from protecting investors to protecting the companies and investment firms that the SEC is required to regulate. As two knowledgeable observers recently wrote: “Created to protect investors from financial predators, the

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and §15(b)(6)(A) extends that duty to individuals in the firm who have supervisory responsibilities.

173. Speer, Leeds & Kellogg, L.P., Exchange Act Release No. 48199, 2003 WL 21688753, at \*7 (July 21, 2003).

174. See ABA Committee on Federal Regulation of Securities, *Broker-Dealer Supervision of Registered Representative and Branch Office Operations*, 44 BUS. LAW. 1361, 1369–75 (1989); Shearson Lehman Hutton, Inc., Exchange Act Release No. 34-26766, 1989 WL 257097 (Apr. 28, 1989).

175. In the Madoff case, Harry Markopolous, a former money manager turned fraud investigator, testified before a congressional committee that the SEC had ignored twenty-nine red flags pointing to Madoff’s alleged Ponzi scheme that he had brought to the agency’s attention over a period of nine years. Joanna Chung & Brooke Masters, *SEC Staff Ineptitude to Blame in Madoff Affair*, FIN. TIMES, Feb. 5, 2009, at 13.

commission has somehow evolved into a mechanism for protecting financial predators with political clout from investors.”<sup>176</sup>

The shift is evidenced by the anti-investor positions that the SEC (as well as a number of former commissioners) has taken in the Supreme Court *amicus* briefs described above. It can also be seen in public statements made by several SEC commissioners, which show a fundamental change in the way the SEC regards the purposes of the securities laws. From the time that the Exchange Act was enacted until about the late 1970s, it was generally accepted that curbing fraud and manipulation not only protected investors but also was good for the health of the economy. As the Supreme Court stated in 1979, “investor protection was [not] the *sole* purpose of the Securities Act. . . . Indeed, Congress’ primary contemplation was that regulation of the securities markets might help set the economy on the road to recovery.”<sup>177</sup> In the eyes of Congress, the aim of the Exchange Act was:

to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.<sup>178</sup>

Thus, in the eyes of Congress and the Supreme Court, effective regulation of the securities markets would contribute to, not detract from, economic growth.

This is not the view that has prevailed at the SEC during recent years. Instead, several commissioners have made it clear that they see regulation not as part of the essential infrastructure of the economy but rather as a restraint on it. Their public utterances have sent a not-too-subtle message to Wall Street and corporate management that the SEC is not inclined to take its regulatory tasks too seriously. In 2004, SEC Commissioner Paul Atkins told the Securities Traders Association that “the government’s intrusive involvement in the markets during the Great Depression” prolonged the Depression, and “Wall Street became the easy scapegoat for the economic

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176. Michael Lewis & David Einhorn, *The End of the Financial World As We Know It*, N.Y. TIMES, Jan. 4, 2009, at 9, available at <http://www.nytimes.com/2009/01/04/opinion/04lewiseinhorn.html>.

177. *United States v. Naftalin*, 441 U.S. 768, 775 (1979) (citing S. Rep. No. 47, 73rd Cong., 1st Sess. (1933)).

178. *Id.*

deterioration within the United States.”<sup>179</sup> The following year, SEC Chairman Christopher Cox, speaking to the Economic Club, quoted approvingly a statement by FRB Chairman Alan Greenspan that “the best investor protection is a growing economy and a rising market” and added: “[A]ll that the SEC does – or should be doing for our country – is meant to help create and sustain an environment that promotes economic growth. . . . In other words, if it ain’t broke, don’t fix it.”<sup>180</sup> Thus did Chairman Cox encapsulate the Commission’s apparent policy of doing nothing until a massive fraud is brought to its attention by someone else. And in 2006, Commissioner Atkins told the U.S. Chamber Institute for Legal Reform: “[W]e must not allow the American economy to be encumbered by a web of excessive regulations that fail the cost/benefit test.”<sup>181</sup> As yet another example, Commissioner Kathleen Casey has publicly expressed disagreement with the long-standing court decisions giving defrauded investors an implied right of action under Rule 10b-5.<sup>182</sup>

In speeches to industry groups, SEC commissioners listed capital formation as one part of a tripartite mission of the agency, the other two parts being investor protection and maintaining fair, orderly, and efficient markets.<sup>183</sup> If investor protection is just one of three independent goals of the SEC, it is easy to take the next step and conclude that regulation should be reduced in order to promote capital formation. That view is inconsistent with the underlying philosophy of the Exchange Act: that prevention of fraud, maintaining of fair and orderly markets, and assurance of honest corporate disclosure are the essential underpinnings of capital formation.

## B. STAFF ISSUES

The so-called “revolving door” between employment at the SEC and the private sector has been cited as a reason why SEC staff members do not pursue investigations of possible misconduct with greater vigor. The theory is that staff members see their time at the Commission as a stopping-off place before accepting a much higher paying job at a Wall Street firm, and that, because they want to maintain good relations with Wall Street, they are not diligent as investigators or examiners.<sup>184</sup> The enormous rise in Wall

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179. Speech by SEC Commissioner Paul S. Atkins before the Securities Traders Association (Oct. 7, 2004), at 1–32.

180. Speech by SEC Chairman Christopher Cox before the Economic Club (Dec. 12, 2005), at 3.

181. Speech by Commissioner Paul S. Atkins before the U.S. Chamber Institute for Legal Reform (Feb. 16, 2006), at 1.

182. Speech by SEC Commissioner Kathleen L. Casey before the Institute for Legal Reform’s Legal Reform Summit (Oct. 24, 2007), at 7 (“I believe it is the role of Congress, not the courts, to decide whether a private right of action against third parties exists”).

183. *See, e.g., id.* at 1.

184. *See* Lewis & Einhorn, *supra* note 176, at 9 (“If you work for the enforcement division of the S.E.C. you probably know in the back of your mind, and in the front too, that if you maintain



Street compensation during the past few years has increased that negative incentive.<sup>185</sup> This is supported by the Senate report into a failed SEC investigation of possible insider trading by Pequot Capital Management, which found:

delays in the investigation, disclosure of sensitive case information by high-level SEC officials to lawyers for those under scrutiny, a detrimental narrowing of its scope after a meeting with a Pequot lawyer, and the appearance of ‘undue deference’ to a prominent Wall Street executive that resulted in the postponement of his interview until after the case’s statute of limitations had expired.<sup>186</sup>

The findings of the Pequot report suggest the possible exercise of political influence on senior SEC officials, but do not necessarily point to a systemic problem of deference to Wall Street by SEC staff members. A more plausible reason for the high turnover rate is that large salaries in the private sector have been an almost irresistible lure to young professionals, particularly those with large student loans.<sup>187</sup> One result is that SEC investigators and examiners do not stay long enough to be properly trained and to acquire the experience necessary to understand complex financial instruments and make discerning judgments as to whether a given investigative lead should be pursued or dropped.<sup>188</sup>

Another problem, related perhaps to the shortage of training and experience of staff members, is that SEC enforcement officers have an incentive to rack up a large number of “successes” by bringing easy cases, which the firm, or individual, is likely to settle and which do not require a lengthy investigation or an understanding of complex securities.

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good relations with Wall Street you might soon be paid huge sums of money to be employed by it.”).

185. See Krugman, *supra* note 130, at A45 (“The incomes of the richest Americans have exploded over the past generation, even as wages have stagnated; high pay on Wall Street was a major cause of that divergence.”).

186. Gretchen Morgenson & Walt Bogdanich, *Report Says S.E.C. Erred on Pequot*, N.Y. TIMES, Aug. 4, 2007 at 1, available at <http://www.nytimes.com/2006/10/22/business/22hedge.html>. The report by the Senate Finance and Judiciary committees was prompted by an accusation that Gary J. Aguirre, a SEC staff member, had been fired in order to prevent him from pursuing an investigation into the possible insider trading by Pequot and that John J. Mack, a Wall Street executive and major fund-raiser for President Bush’s 2004 campaign had been given special treatment by not taking his testimony when Mr. Aguirre wanted to. Walt Bogdanich & Gretchen Morgenson, *S.E.C. Inquiry on Hedge Fund Draws Scrutiny*, N.Y. TIMES, Oct. 22, 2006.

187. A former SEC examiner wrote: “The revolving door there is the biggest problem. Many staff members who are ambitious and competent quit to pursue jobs in the financial industry that pay multiple times their former government salaries.” Eric W. Bright, Letter to the Editor, *It Isn’t Surprising That SEC Missed Madoff’s Scam*, WALL ST. J., Dec. 23, 2008, at A12.

188. According to William J. Brodsky, CEO of the Chicago Board Options Exchange and a former senior officer of the American Stock Exchange and the Chicago Mercantile Exchange, financial illiteracy among SEC staff made it easier for Mr. Madoff’s alleged fraud to go undetected. “The people doing the examinations have no clue what the right questions are to ask,” Mr. Brodsky told a reporter. Joanna Chung et al., *French Madoff Investor Found Dead*, FIN. TIMES, Dec. 24, 2008, at 1.

### C. BUDGETARY RESTRAINTS

Lack of resources is another frequently cited reason for the SEC's failure to detect large frauds. The number of employees in the SEC's enforcement division actually decreased between 2005 and 2007—from 1,338 to 1,192; and the number of examiners has not increased since 2002, even though the number of investment advisors increased by 50 percent during this period.<sup>189</sup>

Whether or not the SEC has sufficient resources is not clear. Between 2000 and 2008, the agency's budget increased by 140 percent, from \$377 million to \$906 million; but the number of staff positions increased by only 20 percent, from 3,235 to 3,868.<sup>190</sup> Even if inflation of salaries is taken into account, the SEC received a very substantial increase in funding during this period.

Two points are relevant here. First, the SEC collects more in fees each year than it is appropriated by Congress. In 2008, for example, the agency collected \$1.15 billion in fees, \$209 million more than its budget.<sup>191</sup> The fact that corporations and Wall Street firms, not taxpayers, pay for securities regulation would argue for increasing the budget, while making sure that the SEC's resources are properly used. Arthur Levitt, SEC Chairman during the Clinton administration, believes that the SEC's "leadership must identify the biggest possible risks to investors and to the entire system and focus resources on these areas."<sup>192</sup>

Second, it is clear that no matter how much money is appropriated, the SEC will never have enough resources to adequately protect investors against fraud, manipulation, and inadequate or inaccurate corporate disclosure. Over forty years ago, the Supreme Court recognized this, stating that private enforcement of the securities laws "provides a necessary supplement to Commission action."<sup>193</sup> Although in recent years the Court, on the whole, has not been friendly to the implied right of action, it has, on several occasions, reaffirmed that a private right exists under Rule 10b-5. It is sound policy, as well as morally right, for the SEC, in its public utterances and in arguing before the federal courts, to support private litigants asserting their rights under the securities laws. These suits provide essential help to the SEC in its enforcement activities.

### D. FRAGMENTED REGULATION

Yet another reason often given for the SEC's ineffectiveness is that, unlike in most countries, financial regulation in the United States is

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189. Chung & Farrell, *supra* note 170, at 16; Arthur Levitt, Jr., *How the SEC Can Prevent More Madoffs*, WALL ST. J., Jan. 5, 2009, at A13.

190. SEC ANN. REP. 1, 159 (2000); SEC ANN. REP. 1, 9 (2008).

191. SEC, Fiscal Year 2009 Congressional Justification, at 5 (Feb. 2008).

192. Levitt, Jr., *supra* note 189, at A13.

193. J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

fragmented. Securities transactions are regulated by the SEC; commodities by the Commodity Futures Trading Commission (CFTC); banks by three federal agencies: the FRB, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation; and insurance by state regulators.

There is little rationale for this complex division of regulatory responsibility, particularly because some kinds of financial instruments do not fall neatly into one category: for example, variable annuities are both insurance policies and securities; futures on foreign currencies are regulated by the CFTC and options on foreign currencies by the SEC, although traders use both kinds of instruments for similar purposes of hedging and speculation.<sup>194</sup> Indeed, some financial instruments, such as non-standardized credit default swaps (which have added greatly to systemic risk during the credit crisis), are not regulated at all.

The SEC's internal structure is similarly fragmented and has not kept pace with changes in the markets. Its three traditional operating divisions, Investment Management, Trading and Markets, and Corporation Finance, organized along the lines of the three major federal securities statutes, remain isolated from each other. They report to the five-member Commission, "which has no real coordinating and integrating facilities of its own."<sup>195</sup>

In March 2008, following disclosure of the enormous losses suffered by several of the largest brokerage firms from investments backed by defaulted mortgages, the Treasury Department issued a report containing a "Blueprint" for regulatory reform.<sup>196</sup> The Treasury proposed that financial institutions be regulated by four federal agencies: (1) the FRB, which would be responsible for overall conditions of financial market stability that could affect the economy; (2) a newly established Prudential Financial Regulatory Agency, which would impose requirements of capital adequacy, risk management and the like; (3) a newly established Conduct of Business Regulatory Agency, which would be responsible for business conduct across all types of financial firms; and (4) the SEC, which would continue to be responsible for corporate oversight in public securities markets, including corporate disclosures, corporate governance, and accounting and auditing oversight.<sup>197</sup>

The Treasury Blueprint of course does not solve the problem of regulatory fragmentation; it simply fragments regulatory responsibility in a

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194. When the CFTC was established in 1974, the majority of futures trading took place in the agricultural sector; today, it encompasses a vast array of complex financial futures contracts.

195. DAVID SILVER, PRESENTATION AT THE ANNUAL INVESTMENT MANAGEMENT CONFERENCE (Mar. 22, 2004), [http://www.sechistorical.org/collection/papers/2000/2004\\_0423\\_Silver.pdf](http://www.sechistorical.org/collection/papers/2000/2004_0423_Silver.pdf).

196. THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 137–38 (Mar. 2008), <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

197. *Id.*

new way. Although it is not at all clear that the recommendations of the Blueprint will be implemented, the fact that they were made at all is significant. A year before the SEC's seventy-fifth birthday, the Treasury Department proposed that the agency be stripped of most of its regulatory responsibility, including all authority over the business conduct and financial responsibility of brokerage firms. But for the low esteem into which the agency had sunk, even before the demise of several huge investment banks and the revelation of the Madoff Ponzi scheme, it was inconceivable that such a proposal would have been made at all.

## V. CONCLUSION

I have tried in this article to summarize the history of the SEC, to pinpoint its principal failures, and to suggest the reasons for the failures. Although factors such as insufficient resources and inadequate training of staff members may have played a part in the Commission's decline, the main reason, in my opinion, is the ethos of deregulation that has prevailed during recent years, not just at the SEC but also in the legislature and the judiciary. In some instances, when the Commission has attempted to assert regulatory authority over new actors in the market or investment vehicles, the courts, interpreting the securities laws narrowly, have voided the SEC's actions.<sup>198</sup> Congress too, in the so-called Reform Act of 1995, showed far more concern about frivolous law suits than about protecting investors.<sup>199</sup>

The first thing the SEC must do is to recapture its activism of the 1930s and 1960s. It must continually keep itself familiar with new types of financial instruments and financial entities, if necessary through in-depth studies of the particular segments, activities, and actors in the markets. The new administration should appoint commissioners who believe that strong regulation benefits not only investors but, in the long run, the securities industry, the markets, and the economy. Some commissioners might come from the ranks of state securities regulators, who seem to have been the only persons with anything resembling the regulatory fervor of the early days of the Commission.

It might also be beneficial for at least one commissioner to be appointed from among the ranks of long-term career staff members. This would be a strong signal that working at the SEC as a lawyer, economist, or accountant can be a career, not just a job before moving on to Wall Street, a law firm or a corporation. Despite the staff problems mentioned above and the criticism

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198. *See, e.g.,* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006) (voiding requirement that hedge fund managers register under the Investment Advisers Act of 1940); Business Roundtable v. Sec. Exch. Comm'n, 905 F.2d 406 (D.C. Cir. 1990) (holding that the SEC does not have authority over stock exchange listing standards).

199. The Private Securities Litigation Reform Act is codified in Securities Act of 1933 §27A (2003) and Securities Exchange Act of 1934 §21E (2004). It was enacted in late 1995 over the veto of President Clinton.

leveled over the Madoff affair, the SEC has always had a tradition of a strong, independent-minded staff, sometimes to the chagrin of the commissioners. Including a career employee on the Commission would create closer ties between the Commission and the staff and help keep the Commission more aware of the problems and issues that the staff faces every day.<sup>200</sup> Furthermore, academics, including William O. Douglas and William L. Cary, have been among the most effective past commissioners; law and business schools continue to be sources of talent.

Most important, the SEC must again see itself as the defender of investors and a counterweight to securities-industry and corporate lobbyists, who have the money, the lawyers, and the political influence to defeat or water down regulatory proposals. On the federal level at least, the SEC is the investor's only champion.

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200. In the 1960s and 1970s, several career staff members became highly effective commissioners; one of them, Manuel Cohen, served as SEC Chairman from 1964 to 1969. In recent years a few commissioners, including Harvey Goldschmid and Annette Nazareth, had previously served as senior staff members. None of them, however, was a career SEC employee.