1998

The Challenge to Financial Regulators Posed by Social Security Privatization

Roberta S. Karmel

THE CHALLENGE TO FINANCIAL REGULATORS POSED BY SOCIAL SECURITY PRIVATIZATION*

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INTRODUCTION

The idea of private investment accounts, as an alternative or supplement to Social Security is rapidly taking hold of the political imagination.[1] There is a significant variation, however, in the ideas for Social Security privatization. Some proposals would raise the payroll tax and then let the Social Security trust fund invest in pools of common stocks instead of govern-

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[1] A Federal Advisory Panel on Social Security, appointed in 1994 and headed by Edward M. Gramlich, issued a report in January 1997 that reflected the Panel's inability to agree on one single plan for dealing with Social Security's financial difficulties. However, 7 of 13 members recommended compulsory private saving through individual investment accounts. *See* Robert Pear, *Panel on Social Security Urges Investing in Stocks, But Is Split Over Methods,* N.Y. TIMES, Jan. 7, 1997, at A1; *see also* Jackie Calmes, *Social Security Report Opens Debate,* WALL ST. J., Jan. 7, 1997, at A2. The initial White House response was that any plan to put Social Security funds in the stock market raises concerns about risk, no matter whether the government or individuals decide where funds should be invested. Jackie Calmes, *Clinton Panel Cites "Risk" in Putting Social Security Funds in Stock Market,* WALL ST. J., Feb. 11, 1997 at A2. A subsequent Federal Advisory Committee, headed by Donald Marron, unanimously recommended that Social Security be supplemented by individual investment accounts. *See* Richard W. Stevenson, *Bipartisan Plan for Rescue of Social Security Involves Markets and Retirement at 70,* N.Y. TIMES, May 19, 1998, at A17; *see also* Judd Gregg et al., *A Look at . . . The Future of Social Security,* WASH. POST, June 7, 1998, at C3. This idea began to have liberal as well as conservative backing. *See, e.g.,* Gerald F. Seib, *Moving Beyond Simply "Saving" Social Security,* WALL ST. J., Mar. 25, 1998, at A24. Then, President Clinton voiced interest in investing some of the Social Security trust fund in the stock market. *See* Christina Duff, *Clinton Willing to Consider Investing Some Social Security Funds in Stocks,* WALL ST. J., July 28, 1998, at A4.

ment bonds as the fund does currently.[2] An alternative would change the present Social Security defined benefit system to a defined contribution system.[3] The most free market version of this idea would permit persons to invest as they choose, although perhaps only through certified financial institutions.[4] Others contemplate that the private investment accounts would be allocated by the Social Security Administration into a menu of from five to ten broad market index funds, covering both stocks and bonds.[5] Under any of these ideas, there are further questions about whether, upon reaching retirement age, accumulated funds should be distributed, or converted to annuities.[6]

In addition to the possibility of Social Security privatization, there is a growing preference by both employers and employees for defined contribution pension plans rather than defined benefit pension plans in the private sector.[7] These trends are not only ongoing in the United States but also worldwide.[8] Accordingly, an increasing number of individuals will be obliged to take responsibility for the investment of their pension funds, and more of these funds are likely to be channeled into stock markets as opposed to government debt. While governments may decide to control individual investment deci-

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[2] EDWARD M. GRAMLICH, IS IT TIME TO REFORM SOCIAL SECURITY? 58 (1998). In my view, this is not true privatization, especially if the funds are simply invested in index funds. On the other hand, it can be argued that allowing the government selectively to invest the trust fund in the private capital markets would amount to socialization of the economy. *See* Krzysztof M. Ostaszewski, *Privatizing the Social Security Trust Fund? Don't Let the Government Invest*, 6 SOC. SECURITY PRIVATIZATION, Jan. 14, 1997, at 1.

[3] GRAMLICH, *supra* note 2, at 60.

[4] GRAMLICH, *supra* note 2, at 62.

[5] GRAMLICH, *supra* note 2, at 64.

[6] GRAMLICH, *supra* note 2, at 62.

[7] *See* Janice Koch, *Performance Anxieties*, INSTITUTIONAL INVESTOR, Mar. 1, 1998, at 89, 90; *see also* SEC STAFF REPORT, PROTECTING INVESTORS: A HALF-CENTURY OF INVESTMENT COMPANY REGULATION, *reprinted in* Fed. Sec. L. Rep. (CCH) No. 1504, at 136-44 (May 29, 1992) [hereinafter PROTECTING INVESTORS].

[8] *See* GROUP OF TEN, THE MACROECONOMIC AND FINANCIAL IMPLICATIONS OF AGING POPULATIONS 25-29 (1998); *see also* Joel Millman & Craig Torres, *Mexico to Allow 12 Companies to Offer Pension-Fund Services*, WALL ST. J., Jan. 29, 1997, at A7; Peter Passell, *How Chile Farms Out Nest Eggs*, N.Y. TIMES, Mar. 21, 1997, at D1; Ellen E. Schultz, *Going, Going ...Global: 401(k) Plans*, WALL ST. J., Nov. 26, 1996, at C1; Craig R. Whitney, *In Europe, Too, Social Security Isn't So Secure*, N.Y. TIMES, Aug. 31, 1997, § 4, at 4; *Japan's Debt-Ridden Future*, ECONOMIST, Aug. 3, 1996, at 31.

sion-making under a Social Security privatization plan to a greater or lesser extent, the possible implications for securities regulatory regimes are significant.

At a time when stock markets are at all time highs, encouraging pension fund equity investments may seem like a brilliant idea. After a serious stock market crash or a prolonged bear market, such investments may seem to have been ill-advised.[9] What should the responsibility of government be for investor protection under a new regime in which more retirement funds are subject to stock market risks as well as rewards? Over the past few decades, securities regulation in the United States has been relaxed in a number of areas.[10] Some of this deregulation is part of a general political trend; some has been justified on the theory that stock markets have become institutionalized, financial institutions do not necessarily need the protection of the federal securities laws and a long bull market has diminished the clamor for rigorous investor protection. In other countries, securities regulation has remained less rigorous than in the United States because such countries do not have a long-standing culture of equity investment by individuals.[11]

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[9] In October 1987 the stock market declined 30% in less than one week. *See* REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS, *reprinted in* Fed. Sec. L. Rep. (CCH) Special Report No. 1267, at 15 (Jan. 12, 1988). Also, the markets for stock options and financial futures behaved as one market, *id.* at 55, and the market break in the United States triggered similar breaks all around the world. *Id.* at 9-14. Further, the psychological and economic effects of a bear market can last a long time. *See* Bernard Wysocki, Jr., *"Wealth Effect" Tends to Linger on for Years*, WALL ST. J., Aug. 10, 1998, at A1. During the summer of 1998, $4 trillion of the world's financial wealth was wiped out by stock declines. *The World Economy On the Edge*, ECONOMIST, Sept. 5, 1998, at 19. Further, this decline had international effects. *See* Michael R. Sesit & Sara Webb, *Wall Street Takes the Globe on a Wild Ride*, WALL ST. J., Sept. 2, 1998, at C1, C14. Critics of privatizing Social Security point out that privatization subjects workers to investment risks. *See, e.g.*, Kathryn L. Moore, *Privatization of Social Security: Misguided Reform*, 71 TEMP. L. REV. 131, 156 (1998). Others argue that, over time, returns from equity investment exceed Social Security returns. *See, e.g.*, Melissa Hieger & William Shipman, *Common Objections to a Market-Based Social Security System: A Response*, 10 SOC. SECURITY PRIVATIZATION, July 22, 1997, at 8-10; *see also* Robert Pear, *Panel in Discord On the Financing of Social Security*, N.Y. TIMES, Dec. 8, 1996, at 38.

[10] *See infra* notes 61-63.

[11] *See, e.g.*, Mark J. Roe, *German Codetermination and German Securities Markets*, 1998 COLUM. BUS. L. REV. 167, 169; Deborah Ball, *New Entrepreneurs Fuel IPO Bonanza in Italy*, WALL ST. J., July 22, 1998, at B7.

Generally, the securities industry has been supportive of ideas to privatize Social Security and put more retirement savings into the public securities markets.[12] Others have favored such a trend because they believe this would make for greater efficiency in the allocation of capital throughout the economy and would represent a retreat from a mixed economy to a purer form of capitalism.[13] Little attention has been paid, however, to the possibility that such development could well lead to more aggressive and far reaching regulation by the Securities and Exchange Commission ("SEC") and other financial regulators, thus reversing the deregulatory trend of the past two decades.

If the United States and other governments that have provided economic safety nets for their older citizens reduce such retirement protection or turn this task over to the private sector, demands for other assurances of financial security may be heard. Indeed, it would be irresponsible for government to transfer its obligations to provide pensions to its citizens to the private sector and then not assure that the funds to pay such pensions will be forthcoming. Specifically, two different problems emerge—first, the problem of whether total investment return will at least equal current payouts and second, the solvency of any financial intermediaries holding pension funds. This Article will outline some of the many possible reforms likely to be considered or adopted by financial regulators to accompany Social Security privatization. Such increased regulation could be imposed directly, or indirectly, as conditions for the investment of funds into the public equity securities markets, whether or not such investment is made by the Social Security Administration, by individuals or by "certified" or "approved" mutual funds.

Part I of this Article will outline some of the substantive changes that might be made to ensure that equity investments are not made in highly risky ventures. Such changes could

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[12] *See, e.g., Broker-Dealer Duties, Preemption, CEA Reform Issues Confront Congress*, 29 Sec. Reg. & L. Rep. (BNA) 70 (Jan. 17, 1997); Jackie Calmes, *Wall Street Quietly Promotes Social Security Overhaul*, WALL ST. J., Dec. 3, 1996, at A24.

[13] *See* Martin Feldstein, *Privatizing Social Security, The $10 Trillion Opportunity*, 7 SOC. SECURITY PRIVATIZATION, Jan. 31, 1997, at 2-4; Mark Weinberger, *Social Security: Facing the Facts*, 3 SOC. SECURITY PRIVATIZATION, Apr. 10, 1996, at 8-9.

include limitations on investment options involving a reconsideration of the efficacy of merit regulation, the institution of company registration and greater regulatory scrutiny of new financial products. More stringent safety and soundness requirements of financial intermediaries might also be put on the table in order to guard against insolvencies and systematic risk. In particular, increased investment adviser regulation will be addressed.

Part II of this Article will discuss possible procedural or jurisdictional changes in financial regulation that Social Security privatization could prompt. Generally, more centralized regulation is likely. This could involve continued preemption of state securities laws, a continued shift to the federal government of responsibility for bank regulation, the shift to the federal government of regulation of insurance companies and the consolidation of federal regulatory agencies. Although most of this Article will focus on possible changes to financial regulation in the United States that could accompany Social Security privatization, Part III of this Article will discuss the implications for U.S. financial regulators of cross-border investments by private investment accounts.

Forecasting the future is uncertain. The ideas in this Article are the Author's own views about the kind of regulatory initiatives that are in accord with the long term "wish lists" of the SEC and other regulators and that could be defended politically as appropriate to accompany Social Security privatization. Whether any or all of them would ever be adopted depends on a variety of political and economic factors beyond the purview of this Author's crystal ball.

I. QUALITATIVE STANDARDS FOR SECURITIES INVESTMENTS AND INTERMEDIARY RESTRICTIONS

A. *Regulation of Issuers*

1. Merit Regulation versus Full Disclosure

Before the first federal securities law, the Securities Act of 1933 ("Securities Act"),[14] was enacted, there was considerable

[14] 15 U.S.C. §§ 77a *et seq.* (1998).

debate about the extent to which the federal government should control capital formation. One group advocated the full disclosure view, suggested many years before by Louis D. Brandeis: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[15] Others argued for more direct control of the sale of securities by the federal government. Early drafts of federal legislation would have prohibited any securities distribution by an issuer if the business of the company or its securities were not sound or the issuer was found to be dishonest or in unsound condition.[16] The Securities Act was a political compromise between critics of bankers, corporate directors, and accountants who questioned the value of the private enterprise system and the business community which strenuously objected to the control of capital raising by a federal bureaucracy. Full disclosure, rather than merit review, was selected as the regulatory model.[17]

Nine months after the Securities Act was adopted, William O. Douglas published a strong critique of the statute. In his view, the Securities Act was a failure because it "presupposes that the glaring light of publicity will give investors needed protection" but investors "either lack the training or intelligence to assimilate . . . and find . . . useful" the balance sheets, contracts or other data in the registration statement "or are so concerned with a speculative profit as to consider them irrelevant."[18] According to Douglas, the reliance placed on truth about securities was unrealistic because it ignored the modern development of big business. Douglas espoused a regulatory theory that was an integral part of a whole program of industrial regulation and organization for a modern and complex economy. Control over access to the capital markets "would be an administrative control lodged not only in the banks of the

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[15] LOUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).

[16] *See* DONALD A. RITCHIE, JAMES M. LANDIS: DEAN OF THE REGULATORS 43-52 (1980).

[17] *See* LOUIS LOSS & JOEL SELIGMAN, I SECURITIES REGULATION 169-77 (3d ed. 1998).

[18] William O. Douglas, *Protecting the Investor*, 23 YALE L.J. 521, 523-24 (1934).

new self-disciplined business groups but also in the hands of government agencies whose function would be to articulate the public interest with the profit motive."[19]

A year after the Securities Act was passed, Congress passed the Securities Exchange Act of 1934 ("Exchange Act"),[20] creating the SEC and injecting some corporate governance standards into federal law. Short swing profits by officers, directors, and major stockholders in the securities of their companies were prohibited.[21] Federal control was imposed over the proxy solicitations of large public companies.[22] Of great future importance, a catchall antifraud provision was enacted, giving the SEC some rulemaking authority with regard to fiduciary duties.[23] William O. Douglas became a commissioner of the SEC in 1936, after serving on the SEC staff, and served as Chairman of the SEC from September 1937 to April 1939.[24] The securities statutes, which he had a hand in drafting, included controls on capital structure and corporate governance. Specifically, the Public Utility Holding Company Act of 1935[25] imposed various substantive controls upon the capital structure of public utility holding companies. The Trust Indenture Act of 1939[26] gave substantive protections to the bondholder of public corporations and assured that their rights would be protected by indenture trustees. The Investment Company Act of 1940 ("Investment Company Act")[27] created a corporate governance structure for mutual funds, and in particular, a requirement for control by independent directors.[28] In addition, the Investment Company Act regulated the capital structure of mutual funds to assure against excessive leverage.[29] The Investment Advisers Act of 1940 ("Advisers Act")[30]

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[19] *Id.* at 531.
[20] 15 U.S.C. § 78a *et seq.* (1998).
[21] *See id.* § 78p(b).
[22] *See id.* § 78n.
[23] *See id.* § 78j(b).
[24] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 155-56 (1982).
[25] 15 U.S.C. §§ 79-79z-6 (1998).
[26] *Id.* §§ 77aaa-77bbbb (1998).
[27] *Id.* §§ 80a-80a-64 (1998).
[28] *See* Investment Company Act of 1940, § 10(a), 15 U.S.C. § 80a-10(a) (1998).
[29] *See* 15 U.S.C. § 80a-18 (1998).
[30] *See id.* §§ 80b-1 to 80b-21 (1998).

the last of the New Deal federal securities regulatory statutes, sets forth a much less intrusive scheme of regulation for investment advisers.

A merit model of regulation can be found in state blue sky statutes. These statutes give a state, through its blue sky commissioner, the authority to prevent an issuer from selling its securities in that state when the offering or the issuer's capital structure is substantively unfair or presents an excessive risk to investors.[31] While not all states presently have or, in the past have had, merit regulation, as opposed to full disclosure statutes, a sufficient number of states historically retained such laws so as to compel issuers making initial public offerings on a nationwide basis to meet substantive capitalization requirements.[32] Another type of merit regulation can be found in the listing requirements of stock exchanges and the National Association of Securities Dealers Automated Quotation System ("Nasdaq").

The type of capitalization matters addressed by merit regulation include price-offering restrictions designed to prevent undue dilution of shareholders' equity and limits on the entrepreneurial profit that insiders, underwriters and other promoters can make.[33] At the federal level, limitations on the use of cheap stock, options and warrants as a means of compensating underwriters are established by the National Association of Securities Dealers Regulation, Inc. ("NASDR") pursuant to its Rules of Fair Practice.[34] Listing requirements typically address issuer size and earnings history and mandate widespread equity distribution.[35] In 1995, Congress gave the

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[31] *See Report on State Merit Regulation of Securities Offerings [by the Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee],* 41 BUS. LAW. 785, 787 (1986).

[32] *See* Ronald M. Shapiro & Alan R. Sachs, *Blue Sky Law and Practice: An Overview,* 4 U. BALT. L. REV. 1 (1974).

[33] *See* Mark A. Sargent, *State Disclosure and the Allocation of Regulatory Responsibilities,* 46 MD. L. REV. 1027 (1987).

[34] *See* National Association of Securities Dealers, Inc. ("NASD") CONDUCT RULES 2710-2750 (1998).

[35] *See* NYSE LISTED COMPANY MANUAL § 1; *see also* Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act,* 47 BUS. LAW. 1461, 1463-77 (1992); Comment, *Stock Exchange Listing Agreement as a Vehicle for Corporate Governance,* 129 U. PA. L. REV. 1427 (1981); *NYSE Raises Bar on Listing Standards For IPOs, Exchange Transfers, Global Firms,* 30 Sec. Reg. & L. Rep. (BNA) 886 (June 12, 1998).

SEC the power to define "qualified securities" in a national market system; such securities have been defined to include securities listed on a national securities market or Nasdaq.[36] The SEC has articulated further merit standards for issuers by permitting world class companies to use short form registration statements.[37]

Until quite recently, blue sky merit regulation was not preempted by federal securities laws. Both the Securities Act and the Exchange Act had savings clauses specifically assuring against federal preemption.[38] However, most states retained a blue-chip exemption from their blue sky laws for securities that were listed on a national securities exchange and, in some cases, securities that were listed on Nasdaq.[39] This meant that securities offerings which otherwise would have had to be passed upon for fairness could go forward without review by the state blue sky commissioner.

During the mid-1980s, blue sky merit regulation became extremely unpopular. In keeping with a general deregulatory trend in securities regulation, some states repealed merit regulation and replaced it with full disclosure standards.[40] Pressure, nevertheless, began to build for preemption of state blue sky laws, at least as to all national market system securities. Congress acceded to this pressure in 1995 and enacted legislation eliminating blue sky review for all offerings of all national market system securities.[41] This legislation did not affect the NASDR's review of corporate offerings. Rather, it had the effect of putting more responsibility on the NASDR for regulating the fairness of public offerings from a capitalization standpoint.

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[36] Securities Exchange Act of 1934, § 11A(c)(2), 15 U.S.C. § 78k-l(c)(2) (1998); Securities Exchange Act of 1934, Rule 11Aa2-1, 17 C.F.R. § 240.11Aa2-1 (1998).

[37] *See* Securities Act Forms S-1, S-2 and S-3.

[38] *See* Brian J. Fahrney, Comment, *State Blue Sky Laws: A Stronger Case for Federal Pre-Emption Due to Increasing Internationalization of Securities Markets*, 86 NW. U. L. REV. 753, 757-58 (1992).

[39] *Id.* at 760 n.61.

[40] *See, e.g.*, Sidney Sosin & Roger G. Fein, *The Landmark 1983 Amendments to the Illinois Securities Law*, 72 ILL. B.J. 196 (1983).

[41] National Securities Markets Improvements Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996).

Although preemption of blue sky legislation was a deregulatory measure, problems with the low-end of the public offering market caused Congress to pass the Securities Enforcement Remedies and Penny Stock Reform Act to try to regulate offerings for stocks in the under $5 range.[42] Similar recent initiatives directed at microcap stocks have been undertaken by the SEC, NASDR and the states.[43] These programs are directed at broker-dealers rather than issuers and do not directly control issuer capitalization.

If Social Security were to be privatized, Congress could require that equity investments by private investment accounts be limited to national market securities or impose some other merit-based standard on the investment of pension funds. Moreover, Congress could encourage the SEC, by granting further authority to articulate merit standards for national market system securities, to prevent investors from putting their retirement savings into low end speculative securities. Eliminating such speculative risk from the public securities markets could have adverse effects on capital formation, however. While many low priced speculative offerings fail, some succeed and become important contributors to the national economy.[44]

2. Corporate Governance

The Securities Act gave the SEC direct control of securities distributions but little control over day-to-day corporate conduct. However, major amendments to the securities laws in 1964[45] gave the SEC the power to direct a continuous disclosure system for all public corporations. The 1968 Williams Act amendments to the Exchange Act[46] then gave the SEC regulatory authority over tender offers. Although, for the most part,

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[42] Pub. L. No. 101-429, 104 Stat. 931 (1990).

[43] *See NASAA Notes Recent Actions Targeting "Boiler Room" Operations*, 30 Sec. Reg. & L. Rep. (BNA) 1160 (July 31, 1998); *SEC Issues Proposals to Clamp Down on Fraud in Microcap Stock Market*, 30 Sec. Reg. & L. Rep. (BNA) 237 (Feb. 13, 1998).

[44] *See* Gregg Ip, *IPO Profusion: Bull Market Has Sired A Lot of New Stocks, But Few Become Stars*, WALL ST. J., Sept. 15, 1998, at A1.

[45] Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964); *see* Exchange Act Release No. 7425, 29 Fed. Reg. 13455 (Sept. 15, 1964).

[46] 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1998).

these amendments followed a disclosure mode of regulation, the legislation also contained substantive provisions dictating the conduct of contests for corporate control. The SEC's tendency to use disclosure for its prophylactic effect at times has gone so far as to invite criticism. A 1977 Advisory Committee to the SEC was prompted to recommend that the "Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct."[47]

In the context of a judicial climate that favored implied rights of action and liberal interpretations of remedial statutes,[48] the SEC was able to utilize enforcement cases and disclosure rules to impose its notions about corporate governance on public companies. In a wide variety of management fraud cases,[49] disclosure rules concerning management remuneration[50] and hearings concerning corporate accountability,[51] the SEC indicated its interest in generally regulating corporate governance. Thereafter, the securities laws were amended to give the SEC significant new powers for doing so. In 1977, Congress passed the Foreign Corrupt Practices Act,[52] giving the SEC direct authority to regulate the internal accounting controls of public corporations. In addition, in 1984 Congress included in the Insider Trading Sanctions Act[53] a new administrative power to sanction corporate officers responsible for false filings with the SEC.[54]

Over the past two decades, the SEC has been much less aggressive in promoting corporate governance reform, and various institutional investor and other private sector groups have taken up the cause of shareholder democracy.[55] Among other

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[47] HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., REPORT OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SEC 305 (Comm. Print 1977).

[48] *See* Louis Loss, *Introduction: The Federal Securities Code—Its Purpose, Plan, and Progress*, 30 VAND. L. REV. 315 (1977).

[49] *See* ROBERTA S. KARMEL, REGULATION BY PROSECUTION 146-53 (1982).

[50] *See* Securities Act Release No. 5856 (Aug. 18, 1977); Item 402, Regulation S-K, 17 C.F.R. § 229.402 (1998).

[51] Exchange Act Release No. 13,901, 42 Fed. Reg. 44,860 (Aug. 29, 1977); Exchange Act Release No. 13,482, 42 Fed. Reg. 23,901 (Apr. 28, 1977).

[52] Pub. L. No. 95-213, 91 Stat. 1494 (codified at 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78ff (1998)).

[53] Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. §§ 78o(d)(2), 78ff(a)).

[54] 15 U.S.C. § 78o(c)(4).

[55] *See* Dennis J. Block & Jonathan M. Hoff, *Corporate Governance and Institu-*

reasons why the SEC has not sought new opportunities to regulate internal corporate affairs is that the Supreme Court determined that the antifraud provisions of the Exchange Act require deception, manipulation or nondisclosure. Claims cannot be recognized for breaches of fiduciary duty without any charge of manipulation or lack of disclosure.[56] Further, in the battle over dual class voting rights, the SEC endeavored to use its power over SRO rulemaking to impose corporate governance standards on national market system-listed companies, and the D.C. Circuit Court determined that the SEC exceeded its statutory authority by so doing.[57] The SEC has a long institutional memory, however, and when the times are politically receptive, it can be anticipated that the SEC will utilize its powers to advance corporate governance. Less exuberance in the stock market or widespread scandals about a critical corporate governance issue such as executive compensation could impel Congress to increase the SEC's authority to regulate corporate conduct. If this were to coincide with Social Security privatization, the SEC might obtain the authority to enforce directors' fiduciary duties, a power the SEC staff has long advocated.[58]

3. Issuer Registration and Disclosure

The registration provisions of the Securities Act are central to the realization of the law's goal of full disclosure.[59] During the period when the securities laws were expanding in coverage, the SEC insisted on a very narrow reading of exemptions from registration, particularly the private placement exemption.[60] This interpretation was severely criticized by the

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tional Activism, N.Y.L.J., Jan. 18, 1996, at 5; James M. Tobin, *The Squeeze on Directors–Inside is Out*, 49 BUS. LAW. 1707, 1729-36 (1994).

[56] *See, e.g.*, Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

[57] *See* Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

[58] *See* Roberta S. Karmel, *Is It Time For a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 78-81 (1991).

[59] Section 5 has been called the "heart" of the statute. LOSS & SELIGMAN, *supra* note 17, at 388.

[60] *See* William J. Carney, *Exemptions from Securities Registration for Small Issuers: Shifting From Full Disclosure*, 10 LAND & WATER L. REV. 507, 513-44 (1975).

securities bar, and pleas for reform led to the enactment of a clearer and more objective private placement exemption.[61] The development of the "accredited investor" concept by amendment to the Securities Act accelerated the trend toward enlarging the private placement exemption.[62] Indeed, the SEC staff determined to foster the private placement market by adopting improvements to the private placement rules and adding some new rules.[63]

These developments were propelled in part by internationalization and institutionalization of the public securities markets. However, encouraging issuers to avoid the registration process masked technical problems with the registration provisions, which had become increasingly outmoded.[64] Although the SEC had been integrating the Securities Act and the Exchange Act since the early 1980s, moving issuers from transactional disclosure to continuous disclosure, integration of these two statutes remained incomplete.[65] The 1996 Advisory Committee Report, headed by then SEC Commissioner Steven Wallman, recommended that the SEC move to a system of company disclosure.[66] Under such a system, public companies would be able to rely on their continuing SEC-filed disclosure documents when making securities offerings.

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[61] *See* William J. Casey, *SEC Rules 144 and 146 Revisited*, 43 BROOK. L. REV. 571 (1977); Note, *Reforming the Initial Sale Requirements of the Private Placement Exemption*, 86 HARV. L. REV. 403 (1972).

[62] Securities Act of 1933, 15 U.S.C. § 77d(6) (1998). The "accredited investor" exemption was added by section 602 of the Small Business Issuer's Simplification Act of 1980, as a means of easing restrictions on private placements. Soon thereafter the SEC adopted Regulation D. 17 C.F.R. §§ 501-506 (1998).

[63] In addition to adopting Regulation D, 17 C.F.R. §§ 501-506, the SEC liberalized the private placement resale restrictions of Rule 144, 17 C.F.R. § 240.144 (1998), and adopted Rule 144A, 17 C.F.R. § 230.144A (1998), and Regulation S, 17 C.F.R. § 230.901-.904 (1998). *See* Exchange Act Release Nos. 7390, 7391, 7392 [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶¶ 85,907-09, at 89,256, 89,261, 89,279 (Feb. 20, 1997).

[64] *See* SEC, REPORT OF THE ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES (July 24, 1996), *reprinted in* Fed. Sec. L. Rep. (CCH) No. 1726, at 46-51, 55-61 (Aug. 5, 1996) [hereinafter Wallman Report]; *see also How 144A Rules*, INSTITUTIONAL INVESTOR, Aug. 1, 1998, at 28.

[65] *See* Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567, 568-73 (1997). The SEC adopted its integrated disclosure policy in 1982. *See* Securities Act Release Nos. 6383, 6384 and 6385 (1982).

[66] *See* Wallman Report, *supra* note 64.

Little progress has been made by the SEC in the direction of company disclosure. However, the SEC has been rethinking the breadth of some of the exemptions from regulation previously adopted.[67] Further, in recent years the staff has rediscovered the appeal of the registration provisions in exerting leverage over public companies.[68] While company registration could be a solution to many problems that have developed under the registration provisions,[69] company registration has the potential for giving the SEC greater control over internal corporate affairs. Under company disclosure, issuers, rather than securities, would be required to register with the SEC. This subtle shift would make public companies directly, rather than indirectly, subject to the SEC's regulations. Thus, Social Security privatization could give impetus to legislative amendments integrating the Securities Act and the Exchange Act and providing for company disclosure.

B. *New Products Approvals*

The SEC does not generally approve new financial products before they can be marketed. However, the SEC does approve new financial products that national securities exchanges propose to list because the new exchange rules relating to such products must be reviewed and approved by the SEC before they go into effect.[70] The Commodity Futures Trading Commission ("CFTC") similarly has authority to approve the design of all new financial futures listed on any commodities exchange.[71]

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[67] Regulation S is no longer available to U.S. issuers except for the sale of "restricted" securities, *see* Securities Act Release No. 7505, 63 Fed. Reg. 9632 (Feb. 17, 1998), and there is a proposal to eliminate Rule 504. *See* Securities Act Release No. 7541 (May 21, 1998).

[68] *See* Wallman Report, *supra* note 64, at 56; Gerald S. Backman & Stephen E. Kim, *A Cure for Securities Act Metaphysics: Integrated Registration*, INSIGHTS, May 1995, at 18.

[69] *See, e.g.*, Dan L. Goldwasser, *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595 (1986); Carl W. Schneider, *Section 4(1½)-Private Resales of Restricted or Control Securities*, 49 OHIO ST. L.J. 501 (1988).

[70] *See* Securities Exchange Act of 1934, § 19(b)(1), (2), 15 U.S.C. § 78s(1), (2) (1997); SEC Rule 19b-4, 17 C.F.R. § 240.19b-4 (1998).

[71] *See* 7 U.S.C. § 7 (1998).

A significant difference between the commodity futures laws and the securities laws is that virtually all commodity futures are required to be traded on commodity exchanges,[72] whereas securities are not required to be so traded. Accordingly, if a financial product is classified as a security, no prior government approval is required before the product can be sold, although a registration statement might be required if the product is marketed publicly. If the product is classified as a commodity futures contract, however, the CFTC has authority to dictate its design. This difference, among other things, has led to a continuous struggle between securities and commodities regulators, a struggle that has recently erupted over control of the vast derivatives market.[73]

Definitional distinctions also control whether the SEC or other agencies regulate certain insurance and banking products.[74] Defective product design or fraudulent selling practices have separated numerous investors from their savings in both bank and insurance products, and sometimes the SEC has proven a more aggressive regulator than banking or insurance commissioners, claiming jurisdiction over borderline products.[75]

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[72] *See id.* § 6(a) (1998).

[73] *See CFTC Offers Assurances for OTC Market, But Other Financial Regulators Not Convinced,* 30 Sec. Reg. & L. Rep. (BNA) 1162 (July 31, 1998); John C. Coffee, Jr., *The OTC Derivatives Turf War,* N.Y.L.J., July 23, 1998, at 5; Lewis D. Solomon & Howard B. Dicker, *The Crash of 1987: A Legal and Public Policy Analysis,* 57 FORDHAM L. REV. 191, 219-22 (1988).

[74] *See* Reves v. Ernst & Young, 494 U.S. 56 (1990) (notes sold by co-op to raise money to support its general business operations are securities under the Securities Act and the Exchange Act); Securities and Exch. Comm'n v. United Benefit Life Ins. Co., 387 U.S. 202 (1967) (deferred annuity contract held to be an investment contract within the terms of the Securities Act); Securities and Exch. Comm'n v. Bremont, 954 F. Supp. 726 (S.D.N.Y. 1997) (SEC fraud action involving prime bank notes which, had they existed, would have been securities); Securities and Exch. Comm'n v. American Bd. of Trade, Inc., 750 F. Supp. 100 (S.D.N.Y. 1990) (SEC action against corporate sellers of commercial paper and their controlling persons for violations of registration provisions of the Securities Act); *In re* Baldwin-United Corp. Litig., 122 F.R.D. 424 (S.D.N.Y. 1986) (investors' action against broker-dealers and promotional corporation, alleging federal securities violations due to the omission of material information in connection with their sale of single premium deferred annuities).

[75] *See, e.g.,* Securities and Exch. Comm'n v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959) (variable annuities subject to the Securities Act); Securities and Exch. Comm'n v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996) (viatical settlement contracts are not insurance contracts that are exempt from

Although some scholars advocate regulatory arbitrage as efficient,[76] in my view, jurisdictional battles between regulators are unseemly and undermine public confidence in the financial markets and their regulators. If analyzed in the context of Social Security privatization, disputes over the approval and regulation of new financial products raise some interesting issues. Should private investment accounts be allowed to invest in all types of financial products? If so, should regulators be authorized to review the design of new products to determine their degree of risk?

It can be argued that these issues and other issues that have been raised in Part I of this Article do not need to be addressed because it is likely that private investment accounts will be permitted to invest only in certain mutual funds designated by the government.[77] However, utilizing financial intermediaries to review investment products does not solve the basic problem of assuring older citizens a minimum pension. Institutions can be misguided, and their trading tends to exaggerate stock market volatility. Further, the problem of determining what financial products intermediaries should be permitted to purchase and trade and how and by what agencies such financial products should be regulated does not disappear because financial intermediaries are layered between the Social Security Administration and citizens or pensioners. Indeed, this contemplated regulatory scheme only raises problems concerning the regulation of financial intermediaries.

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securities regulation under McCarran-Ferguson Act, but the contracts are not securities subject to federal securities laws because profits from their purchase do not derive predominantly from the efforts of those other than investors); Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230 (2d Cir. 1985) (certificates of deposit sold by the investment firm were "securities" within antifraud provisions of the federal securities laws); Prudential Ins. Co. of Am. v. Securities and Exch. Comm'n, 326 F.2d 383 (3d Cir. 1964) (variable annuity contract plan subject to the Investment Company Act).

[76] *See* Frank H. Easterbrook, *Antitrust and the Economics of Federalism,* 26 J.L. & ECON. 23, 34-35 (1983); Edward J. Kane, *Regulatory Structure In Futures Markets: Jurisdictional Competition Between the SEC, the CFTC, and Other Agencies,* 4 J. OF FUTURES MARKET 367, 383 (1984); *see also* John C. Coffee, Jr., *Symposium on the Regulation of Capital Markets, Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation,* 50 BUS. LAW. 447 (1995).

[77] *See* GRAMLICH, *supra* note 2, at 83-84; Gregg et al., *supra* note 1.

C. *Safety and Soundness Assurances*

Regulators worry about the financial stability of individual financial institutions and about systemic risks to the overall financial system. The customers of financial institutions are protected to a limited extent against loss of the capital they have entrusted to a financial company. In addition, capital adequacy rules protect both the viability of a particular firm and prevent a chain reaction of bankruptcies if a single firm collapses. Yet, different financial regulators apply different types of regulations.

Banks are permitted to use the capital of depositors as bank capital; therefore, federal deposit insurance provided by the Federal Deposit Insurance Corporation ("FDIC") protects such depositors and sustains their confidence to leave their savings with banks. Such deposits have dollar-limited guarantees which are aimed generally at protecting the retail customer.[78] The purpose of deposit insurance is to prevent bank runs; thus, such insurance helps to guard against systemic risk as well as to give individual customers protection.[79] In addition, bank capital adequacy rules are designed to prevent bank insolvencies.[80] Since banks are subject to a dual regulatory system at both the state and federal levels, in the past some state banks were guaranteed only by state guaranty funds. This is no longer the case since some of the state guaranty funds proved inadequate for the protection of depositors.[81] Currently, the FDIC insures all U.S. banks, including savings banks, whether they are chartered nationally or in a state.[82]

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[78] The FDIC is a federally created corporation established to insure the deposits of banks and savings associations. *See* 12 U.S.C. §§ 1811(a), 1813(c)(2) (1998). Depositors of such institutions enjoy deposit insurance not to exceed $100,000 for each depositor at every insured depository institution. *Id.* § 1821(a)(1)(B), (C).

[79] 1A MICHIE ON BANKS AND BANKING § 26½ (1993).

[80] The risk-based capital adequacy rules promulgated by the FDIC are codified at 12 C.F.R. pt. 325 (1998).

[81] *See* David Ibata, *Business as Usual in S&Ls Outside Ohio*, CHI. TRIB., Mar. 16, 1985, at C2; *Quiet Reported as Thrifts Begin to Open Doors; Limited Service Plan Allows Withdrawal of $750 a Month*, AM. BANKER, Mar. 22, 1985, at 1.

[82] *See* 12 U.S.C. § 1813(c)(2) (1998). Credit unions, not technically banks, have different federal regulations and insurance. *See* 12 U.S.C. § 1781(a) (1998).

Customers of brokerage firms also enjoy federal deposit insurance under the Securities Investor Protection Act of 1970[83] ("SIPC") with respect to cash and securities on deposit. However, brokers are not permitted to use these funds in the operation of their own businesses. Rather, all free cash balances and fully-paid-for securities must be segregated for the benefit of their customers.[84] Federal insurance provided by SIPC is subject to dollar limits like bank deposit insurance and has the similar objective of guaranteeing that such customers' property is not lost in the event of an insolvency. In addition, such insurance helps to prevent a chain reaction of insolvencies. Like the bank regulators, the SEC imposes capital adequacy rules on broker-dealers, and these rules are designed to prevent the repercussions of one firm's collapse from spreading to other financial institutions.[85]

The customers of commodity futures merchants are protected by exchange guaranty funds, and systemic risk is guarded against by margin and capital adequacy rules.[86] Insurance company policyholders are likewise protected by guaranty funds and capital adequacy rules.[87] However, since insurance companies are not regulated at the federal level but rather by the states, the viability of state insurance guaranty funds varies as does the financial regulation of insurance companies.

Currently, all of these financial industries are consolidating, within their discrete industries and across industry lines, nationally and internationally. Such conglomeration is consid-

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[83] 15 U.S.C. § 78aaa *et seq.* (1998). The Securities Investor Protection Corporation, a federal insurer similar to the FDIC, is authorized to pay up to $500,000, but not more than $100,000 for a cash claim, to satisfy the net equity claims of customers. *Id.* § 78fff-3(a).

[84] Exchange Act Rule 15c3-3, 17 C.F.R. § 240.15c3-3 (1998).

[85] Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1998).

[86] *See* Commodity Exchange Act, § 4(f), 7 U.S.C. § 6f (1998); Andrea M. Corcoran & Susan C. Ervin, *Maintenance of Market Strategies in Futures Broker Insolvencies: Futures Positions Transfers from Troubled Firms*, 44 WASH. & LEE L. REV. 849, 867-71 (1987); Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry–History and Theory*, 64 TEMP. L. REV. 59, 130-32 (1991).

[87] *See* U.S. GEN. ACCOUNTING OFFICE, RISK-BASED CAPITAL: REGULATORY AND INDUSTRY APPROACHES TO CAPITAL AND RISK 33, 44, 64-67 (GAO/GGD-98-153, July 1998) [hereinafter GAO, RISK-BASED CAPITAL]; *see also* Francine L. Semaya & Lenore S. Marema, *State Insurer Insolvency System in Need of Repair*, NAT'L L.J., Aug. 26, 1996, at C4.

erably ahead of the existing balkanized regulatory system for financial institutions. Although Congress has been attempting to reform federal financial regulation for many years, to date it has not had the political will or wisdom to achieve this goal.[88] The advent of Social Security privatization would give a greater urgency to the need for reform of the regulation of financial institutions because it would transfer savings into the private sector in an amount that would change the nature of the capital markets.[89]

Although crises in the financial markets have tested the current regulatory scheme from time to time, there has not been a sufficiently serious financial crash since 1987 to determine whether current customer insurance and financial adequacy rules are sufficiently stringent to guard against systemic failure.[90] In the past, even if savings were lost because of the failure of a particular financial institution, Social Security served as a safety net of last resort. Today, nearly half of all American households own shares in some form, compared with 25 percent before the 1987 stock market crash and 3 percent in 1929.[91] If Social Security is privatized, virtually all U.S. households will have savings in the stock market, and financial regulators may be forced to look more critically at existing financial requirements to determine whether the financial

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[88] *See* Michael Schroeder, *Senate Bank Panel by 16-2 Vote, Clears Compromise Financial-Services Measure*, WALL ST. J., Sept. 14, 1998, at A4.

[89] It is estimated that there could be 140 million private investment accounts if Social Security is privatized. GRAMLICH, *supra* note 2, at 62. Even if only a small percentage of payroll taxes is put into these accounts and only a small percentage of these funds are invested, directly or indirectly, in the public securities markets, billions of dollars would nevertheless be added to these markets. The Social Security Administration estimates that the size of its fund's portfolio will be $1 trillion by 2014. *Social Securities?*, ECONOMIST, Dec. 14, 1996, at 28.

[90] In 1987, the stock market averages dropped 30% in a week's time. *Report of the Presidential Task Force on Market Mechanisms*, Fed. Sec. L. Rep. (CCH) Special Report No. 1267, at 1 (Jan. 12, 1988). Although no large financial institutions collapsed, the NYSE came very close to closing, and such a move could have triggered a financial panic. TIM METZ, BLACK MONDAY 193-95, 207-09 (1988). On October 27, 1997 the stock market averages fell 554 points, but this was only a 7.2% decline. The market decline in the summer of 1998 may test the sufficiency of financial adequacy rules. *See* Anita Raghavan & Matt Murray, *Financial Firms Lose $8 Billion So Far*, WALL ST. J., Sept. 3, 1998, at A2.

[91] *Grin and Bear it*, ECONOMIST, Aug. 8, 1998, at 15.

institutions holding retirement savings are sufficiently well capitalized and well controlled to withstand the severest of financial shocks.

D. *Regulation of Investment Companies and Investment Advisers*

Investment companies are heavily regulated by the SEC. They must have independent directors on their boards,[92] and such directors must approve any advisory contacts with an investment adviser.[93] Various types of conflict of interest transactions are prohibited or regulated,[94] and capital structures are constrained.[95] In addition, investment companies are subject to the registration requirements of the Securities Act and the annual reporting requirements of the Exchange Act.[96] Nevertheless, as long as the investment policies of an investment company are disclosed and maintained, there are no restrictions on what securities they can buy or sell or the velocity of their trading. Indeed, since open-end investment companies are required to be sufficiently liquid to be able to redeem shares on a daily basis,[97] trading by investment companies significantly contributes to the severity and speed of market declines.[98] Although investment advisory contacts must be reviewed and approved by a board's independent directors, investment companies and their adviser reside under the roof of the same management company. Investment company boards may negotiate fees with the adviser, but it would be extraordinary for an investment company to change advisers.[99]

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[92] The membership of a board of directors of an SEC-registered investment company may not include more than 60% of members who are "interested persons" of the investment company. Investment Company Act, § 10(a), 15 U.S.C. § 80a–10(a) (1998). The SEC staff believes that the number of independent investors should be increased to a majority. PROTECTING INVESTORS, *supra* note 7, at 253-54.

[93] Investment Company Act of 1940, §15(c), 15 U.S.C. § 80a–15(c) (1998).

[94] *See, e.g., id.* §§ 15, 17, 15 U.S.C. §§ 80a–15, 17.

[95] *See id.* § 18(a), 15 U.S.C. § 80a–18.

[96] *See id.* § 24(a), 15 U.S.C. § 80a–24.

[97] *See id.* § 22, 15 U.S.C. § 80a-22. For this reason, open-end investment companies must hold 85% of their assets in liquid securities. *See* PROTECTING INVESTORS, *supra* note 7, at 429.

[98] *See* Solomon & Dicker, *supra* note 73, at 240-46.

[99] The SEC staff has recommended that the independent directors be given the

In contrast to the regulation of investment companies and other financial intermediaries, investment advisers are lightly regulated. SEC-registered advisers are subject to recordkeeping and reporting requirements[100] and must make certain written disclosures to clients.[101] Further, the Advisers Act contains some basic conflict of interest prohibitions.[102] Where an investment adviser obtains custody or possession of a client's funds or securities, the SEC requires such customer's property to be segregated.[103]

There are two important respects, however, in which investment advisers are not regulated. First, there are no qualifications for becoming an investment adviser. Second, investment advisers are not subject to any capital adequacy requirements. There are some states that require individuals to pass the North American Securities Administration Association, Inc. ("NASAA") Series 65 Uniform Investment Law Examination in order to register as an investment adviser. This examination was specifically designed to qualify candidates as investment advisers.[104] However, SEC-registered advisers are exempt from state regulation; thus, they are not required to take the Series 65 examination.[105]

Bills to enhance the regulation of investment advisers were passed by the House of Representatives in 1993 and the Senate in 1994 but never became law.[106] This legislation

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power to terminate advisory contracts, a power they do not now have. *See* PROTECTING INVESTORS, *supra* note 7, at 268-69.

[100] *See* Investment Advisers Act of 1940, § 204, 15 U.S.C. § 80b-4 (1998).

[101] *See* Investors Advisers Act Rule 204-3, 17 C.F.R. 275.204-3 (1998).

[102] Performance fees are not permitted, Investment Advisers Act of 1940, § 203(b), 15 U.S.C. § 80b-3(b), and capacity must be disclosed. *Id.* § 206, 15 U.S.C. § 80b-6(3).

[103] *See* Investment Advisers Act Rule 206(4)-2, 17 C.F.R. 275.206.(4)-2(1) (1988).

[104] *See* North Am. Sec. Admin. Ass'n, Inc. (visited Oct. 15, 1998) <http://www.nasaa.org/exams/series65intro.html>.

[105] Investment Advisers Act of 1940, § 203A, 15 U.S.C. § 80b-3A (1998) provides that an investment adviser is subject either to state or federal regulation. In general, advisers with assets under management of $25 million or more and advisers to investment companies are required to register with the SEC. State regulation of such advisers is preempted.

[106] The House bill, H.R. 578, passed on May 4, 1993. The Senate bill, S. 423, passed on November 20, 1993. The major differences in the bills involved disclosure and suitability requirements. *See* Tamar Frankel, *The Pros and Cons of a Self-Regulatory Organization for Advisers and Mutual Funds, in* INVESTMENT LAW 3 n.1 (1994).

would have provided for the creation of a self-regulatory organization for investment advisers and bonding requirements. The primary purpose of the proposed SRO for advisers was to provide for more frequent examinations and establish required minimum qualifications. This would have effected a fundamental change in the regulatory scheme which the industry opposed.[107] After the balance between federal and state regulation of advisers was altered in 1996,[108] the problems of regulating unqualified and undercapitalized investment advisers was sloughed off to the states.

If Social Security is privatized in a way that permits the owners of private investment accounts to select their own investments, investment advisers to non-institutional investors may become critical financial intermediaries. Congress could limit the management of private investment accounts to SEC-registered advisers, and such a responsibility could lead to a strengthening of their regulation by the SEC. Alternatively, Congress could not impose such a limitation but strengthen the regulation of advisers in other ways, including complete federal preemption of adviser registration and regulation.

In addition, more rigorous requirements could be imposed upon investment advisers to investment companies, especially if private investment accounts are permitted to invest in mutual funds. If so, it is quite possible that the Social Security Administration would certify the funds in which private investment accounts could invest. Perhaps funds certified for investment by the Social Security Administration would have to select advisers on the basis of competitive bids or other objective criteria.[109] Perhaps such funds would be required to hold securities on a long term basis in order to curtail market volatility.[110] Perhaps a majority of investment company directors would be required to be independent, and the compensation of

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[107] *See id.* at 6.

[108] *See infra* notes 115-20.

[109] *Cf.* 41 U.S.C. §§ 253b, 414 (1998).

[110] Since pension funds and defined contribution plans can trade securities without any tax consequences, they have no incentive to hold for the long term. *See* Nicholas de B. Katzenbach, *An Overview of Program Trading and Its Impact on Current Market Practices*, NYSE, Dec. 21, 1987, at 5; Ellen E. Schultz, *Big Redemptions Usually Don't Hurt Returns of Funds*, WALL ST. J., Sept. 10, 1998, at C1.

directors of such funds would be curtailed.[111] If these and similar proposals may seem fanciful, it is only necessary to consider the myriad ways in which the government imposes financial constraints and social policy ideas on business through the tax code and government contract policies to imagine the political appeal of controlling the flow of billions of dollars of capital investment.[112]

II. A SHIFT TO THE CENTER

A. *Altering the Balance Between Federal and State Regulation*

1. Securities Regulation

For over 60 years securities regulation was a dual federal and state system, and Congress was extremely reluctant to use federal securities legislation to preempt state securities or corporation law. During this period, the SEC was perceived by business managers as a more aggressive regulator than state securities regulators; therefore, political opposition to increased SEC jurisdiction was generally at the ready. In the past few years, the balance of federal and state securities regulatory power has shifted markedly in the direction of federal preemption. This is a significant shift caused by a variety of factors. Globalization rendered state securities regulation of new offerings costly and inefficient.[113] Also, deregulation at the federal level proceeded more expeditiously than at the state level. Therefore, a consensus was developed by the securities industry for preemption of financial institution regulation and securities litigation.[114]

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[111] *See supra* note 92; *cf.* I.R.C. § 162(m) (1998).

[112] *See Social Securities?*, ECONOMIST, Dec. 14, 1996, at 28.

[113] *See* Fahrney, *supra* note 38, at 754.

[114] *See* Jeffrey Taylor, *Wall Street Bill Is Likely To* Advance, WALL ST. J., May 15, 1996, at C1; *Broker-Dealer Duties, Preemption, CEA Reform Issues Confront Congress*, 29 Sec. Reg. & L. Rep. (BNA) 66 (Jan. 17, 1997). Although securities firms are more comfortable dealing with the SEC as a regulator than with 50 state securities regulators, industrial corporations prefer dealing with state legislators. *See, e.g., infra* note 124.

The National Securities Markets Improvement Act of 1996 ("1996 Act") accomplished significant preemption of state securities regulation as to securities offerings and money management.[115] The SEC was designated as the exclusive regulator of national securities offerings, eliminating previous state blue sky authority. The states do retain their antifraud enforcement powers but may neither impose registration or qualification on "covered securities" nor regulate the disclosure documents used in offerings.[116] The states are also prohibited from regulating disclosure documents such as proxy statements and annual reports and from conducting merit reviews.[117] The 1996 Act also exempted from state registration and regulation SEC-registered investment companies,[118] sales of securities to "qualified purchasers,"[119] private placements and certain other exempt offerings.[120] The 1996 Act further preempted state blue sky regulation of investment advisers to investment companies, advisers with $250 million under management and certain other advisers operating on a national, rather than state, level.[121]

The 1996 Act was designed to make the SEC the exclusive regulator of securities underwritings and large money managers. A series of court cases in recent years have found preemption of national market system trading activities resulting from SEC oversight and rulemaking.[122] These cases contrast with refusals by the courts to find that SEC rulemaking preempted state anti-takeover statutes during the 1980s.[123] Pending leg-

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[115] Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.). *See generally* Harold S. Bloomenthal, *NSMIA and Preemption of State Securities Registration (Pt. I)*, 20 Sec. & Fed. Corp. L. Rep. (CBC) (May 1998).

[116] Securities Act of 1933, § 18(a), 15 U.S.C. § 77r(a) (1998). Generally, "covered securities" are securities listed on the NYSE, American Stock Exchange or Nasdaq. *Id.* § 18(b)(1)(A), 15 U.S.C. § 77r(b)(1)(A) (1998).

[117] *See id.* § 18(a), 15 U.S.C. §77r(a). There is an exemption for a corporation's state of incorporation.

[118] *See id.* § 18(b)(2), 15 U.S.C. § 77r(b)(2).

[119] *See id.* § 18(b)(3), 15 U.S.C. § 77r(b)(3).

[120] *See id.* § 18(b)(4), 15 U.S.C. § 77r(b)(4).

[121] *See* Investment Advisers Act of 1940, § 203a(a), 15 U.S.C. § 80b-3a(a) (1998).

[122] *See, e.g.*, Orman v. Charles Schwab & Co., 688 N.E.2d 620 (Ill. 1997), *cert. denied*, 118 S. Ct. 1518 (1998); Guice v. Charles Schwab & Co., 674 N.E.2d 282 (N.Y. 1996), *cert. denied*, 117 S. Ct. 1250 (1997); Dahl v. Charles Schwab & Co., 545 N.W.2d 918 (Minn. 1996).

[123] *See* Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496 (7th

islation that would preempt state court, securities fraud actions involving nationally traded securities is strongly backed by industrial as well as securities businesses.[124] This legislation is aimed at closing a perceived loophole in the 1995 Private Securities Litigation Reform Act by extending its standards to actions now being brought in the state courts.[125]

2. Commodities Regulation

Commodities regulation is essentially federal, with only limited areas of state antifraud jurisdiction. The CFTC has exclusive jurisdiction over exchange traded commodities futures contracts.[126] This jurisdiction was designed to preempt the field insofar as futures regulation was concerned, a marked change from regulation prior to the creation of the CFTC in 1974.[127]

The greatest jurisdictional disputes in the commodities area are those between the SEC and the CFTC involving financial futures. Although bills to consolidate these agencies have occasionally been proposed,[128] they have never gone far. The SEC and the CFTC have different oversight committees in Congress, and these committees are not inclined to relinquish their authority. Also, the commodities exchanges are reluctant to be regulated by the SEC.[129]

Cir. 1989); CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987).

[124] *See* Securities Litigation Uniform Standards Act, S. 1260, H.R. 1689, 105th Cong. (1998); *see also House Panel Reports Securities Litigation Standards Bill To Full Committee*, 30 Sec. Reg. & L. Rep. (BNA) 883 (June 12, 1998).

[125] The 1995 Act added section 27 to the Securities Act, 15 U.S.C. § 77aa (1998), and section 21D to the Exchange Act, 15 U.S.C. §78uD (1998). For a description of the legislative history and provisions of this statute see generally LOSS & SELIGMAN, *supra* note 17, at 4636–669.

[126] *See* Commodity Exchange Act, § 2(a)(1), 7 U.S.C. § 2(a)(1) (1998).

[127] *See* H.R. REP. NO. 1383 at 35 (1974); S. REP. NO. 1131 at 6, 23 (1994); *see also* Rice v. Chicago Bd. of Trade, 331 U.S. 247 (1947).

[128] *See* H.R. 718, 104th Cong. (1995); H.R. 2550, 103d Cong. (1993); H.R. 965, 102d Cong. (1991); H.R. 4477, 101st Cong. (1990). Although these bills never became law, legislation to clarify the demarcation between CFTC and SEC regulation has been passed. *See* Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat 2294 (1983) (implementing the Shad-Johnson Accord and codifying it as amended in various sections of 7 U.S.C. and 15 U.S.C.).

[129] *See, e.g., Hearings on H.R. 11955 Before the House Comm. on Agriculture*, 93d Cong. 105, 113-14, 249, 253 (1974).

3. Bank Regulation

State regulation of state chartered banks still operates in tandem with federal bank regulation. However, state bank regulatory authority has been giving way to federal authority as a result of the bank financial crisis of the 1980s and internationalization, among other factors. The deregulation of interest rates by Congress in 1980[130] unleashed pressures for greater bank powers that some states granted to state chartered savings and loan associations with generally dire results.[131] Congressional bailouts of this industry and problems with some state guarantee funds led to a sweeping realignment of the federal regulatory agencies that expanded federal regulatory authority over thrifts and commercial banks and included a new regime of exclusive federal bank insurance.[132] The widespread entry of foreign banks into the United States came to be regulated at the federal level.[133] Moreover, the newly acquired ability of banks to do business and merge across state lines has recently led to the growth of larger interstate banks and bank holding companies regulated at the federal level.[134]

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[130] Such deregulation was accomplished by the Depositary Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980).

[131] *See* Carl Felsenfeld, *The Savings and Loan Crisis*, 59 FORDHAM L. REV. S7, S34-36 (1991). The causes and costs of bank expansion and contraction in the 1980s is summarized in LAWRENCE J. WHITE, WHY NOW? CHANGE AND TURMOIL IN U.S. BANKING 7-12 (Group of Thirty Occasional Paper 38, 1992).

[132] *See* Felsenfeld, *supra* note 131, at S49-55. This was accomplished by the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989); *see also* DiVall Insured Income v. Boatmen's First Nat'l Bank, 69 F.3d 1398 (8th Cir. 1995).

[133] *See* Daniel B. Gail et al., *The Foreign Bank Supervision Act of 1991: Expanding the Umbrella of "Supervisory Reregulation,"* 26 INT'L LAW. 993 (1992); Patricia S. Skigen & John D. Fitzsimmons, *The Impact of the International Banking Act of 1978 on Foreign Banks and Their Domestic and Foreign Affiliates*, 35 BUS. LAW. 55 (1979).

[134] *See* PAULINE FEUER & MELANIE FINE, FEDERAL BANK HOLDING COMPANY LAW §§ 1.01, 1.04(3), 17.01(10)–(17) (1998). Until passage of the Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328 (codified at 12 U.S.C. § 43), bank holding companies could not acquire a bank outside their home state unless the state in which the target was located permitted the acquisition.

4. Insurance Companies

Insurance companies are regulated by state, rather than federal, regulators. This regulation is similar to the regulation of banks and securities firms in that insurers must be chartered, meet capital and solvency requirements and conform to restrictions on their investment portfolios.[135] Although insurance is a business in interstate commerce and, therefore, could be regulated by the federal government,[136] the insurance industry finds major advantages to state regulation, and it will not be easily displaced or changed.[137]

Nevertheless, there are some strong forces pushing insurance companies in the direction of federal regulation. The insolvencies of Mutual Benefit Life Insurance Company in 1991 and Confederation Life Insurance Company in 1994 demonstrated problems with state insurance guaranty funds.[138] A flurry of mis-selling cases against life insurance companies has raised questions about the adequacy of state regulation of insurance products.[139] Most importantly, the conglomeration of financial institutions means that insurance company parents or subsidiaries are now regulated by federal financial regulatory agencies.[140] Further, the need for greater capital resources

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[135] *See* WILLIAM A. LOVETT, BANKING AND FINANCIAL INSTITUTIONS LAW 344-45 (1997).

[136] *See* United States v. South-Eastern Underwriters Ass'n., 322 U.S. 533 (1944).

[137] *See* LOVETT, *supra* note 135, at 345. *But see* Etti G. Baranoff & Daniel Gattis, *Measuring Attitudes Toward Regulation*, BEST'S REV. P/C, Sept. 1998, at 67.

[138] *See* June D'Arista & Tom Schlesinger, *The Emerging Parallel Banking System, in* THE FINANCIAL SERVICES REVOLUTION 497 (Clifford E. Kirsch ed. 1997).

[139] *See, e.g., In re* Prudential Ins. Co. of Am. Sales Litig., 148 F.3d 283 (3d Cir. 1998) (class action by policy holder against life insurer alleging a variety of deceptive sales practices); Duhaime v. John Hancock Mutual Life Ins. Co., 177 F.R.D. 54 (D. Mass. 1997) (class action by policyholders against insurance company concerning alleged deceptive and misleading sales practices); Oswald v. Metro. Life Ins. Co., 968 F. Supp. 639 (M.D. Ala. 1997) (policyholders sued life insurer for fraud and negligence based on misrepresentations allegedly made by insurer); *In re* Prudential Ins. Co. of Am. Sales Prac., 975 F. Supp. 584 (D.N.J. 1997) (policyholders brought class action against life insurer for deceptive sales practices by churning to sell replacement policies and misrepresentations about vanishing premiums and use of insurance policies as investment vehicles); Lott v. Metro. Life Ins. Co., 849 F. Supp. 1451 (M.D. Ala. 1993) (suit by policyholders that life insurance company fraudulently induced them to buy life insurance).

[140] *See* Stephen E. Frank, *Banks & Brokers: Brokers' Insurers Queue Up for Thrift Charters*, WALL ST. J., Sept. 24, 1997, at C1.

on the part of insurance companies is leading to demutualization so that investors, as well as policyholders, will now have an interest in insurance rates and the development of new products.[141] Moreover, investors generally look to Washington rather than the states for protection.

Privatization of Social Security, however, could be a new and more urgent cause of a reconsideration of federal regulation of insurance. This is because the most likely way in which the holder of a private investment account will receive retirement income upon reaching retirement age will be to purchase an annuity.[142] This means that the federal government will have a serious interest in assuring the viability of such an annuity, which is an insurance product. The government could set up its own insurance corporation to provide annuities, or it could mandate the purchase of annuities from a private sector insurer. However, it would be anomalous for a retirement annuity mandated by federal law to be differently regulated and insured depending on the state in which the insurance company issuing the annuity is incorporated. Further, some type of federal government guaranty that the annuity be paid would seem necessary instead of reliance on the state insurance guaranty funds.

5. Pensions

Prior to the mid 1970s, corporate pensions were regulated on the federal level, if at all, by the Internal Revenue Service. However, many pension funds lacked sufficient funding or reserves and when a company went out of business or its plan terminated, the pension benefits of many workers were impaired.[143] Other serious problems included delays in vesting and lack of portability.[144] The Employee Retirement Income Security Act of 1974 ("ERISA")[145] addressed these problems

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[141] *See* Michael A. Cohen et al., *End of an Era?*, BEST'S REVIEW P/C, Aug. 1998, at 75.

[142] *See* Moore, *supra* note 9; Mary Jane Fisher, *Major Social Security Reforms Proposed*, NAT'L UNDERWRITER, LIFE & HEALTH/FIN., May 25, 1998, at 1.

[143] *See* LOVETT, *supra* note 135, at 402.

[144] *See* International Bd. of Teamsters v. Daniel, 439 U.S. 551 (1979).

[145] Pub. L. No. 93-405, 88 Stat. 829 (1974) (codified as amended in 29 U.S.C. § 1001 (1998)).

and, among other things, strengthened funding and fiduciary discipline and established the Pension Benefit Guaranty Corporation ("PBGC") to ensure that vested benefits would survive plan terminations.

ERISA mandates fiduciary responsibility for investment managers, trustees or any other person with control over a pension plan or its assets.[146] However, the managers used by private pension funds are not regulated by any one regulator. A large number of plans are managed by insurance companies regulated by state insurance commissioners.[147] Most of the remaining private pension funds are managed by banks, and the federal and state banking laws provide guidelines for their investment management.[148] Where funds are managed by broker-dealers or by mutual funds, there are no investment guidelines.[149]

The PBGC insures vested pension benefits. If a pension plan is terminated, the PBGC guarantees basic, vested benefits, up to a monthly dollar limit, for defined benefit plans.[150] However, the PBGC does not insure defined contribution plans. Further, it does not actively monitor the financial soundness of pensions and has limited corrective order authority.[151]

The Department of Labor and the Internal Revenue Service share responsibility for pension plan supervision under ERISA. Suits to enforce the fiduciary liabilities arising under ERISA may be brought by the Secretary of Labor, plan participants or beneficiaries or other fiduciaries.[152] Interestingly, ERISA preempted state law as to these and other matters.[153] Such preemption includes possible state common law claims.[154]

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[146] *See* 29 U.S.C. §§ 1002 (21)(A), 1104(a) (1998).

[147] *See* LOVETT, *supra* note 135, at 408-09.

[148] *See id.*

[149] *See id.*

[150] *See* 29 U.S.C. §§ 1322, 1322a, 1322b (1998); Barry Rehfeld, *David and the Pension Goliaths*, INSTITUTIONAL INVESTOR, Apr. 1, 1998, at 71.

[151] LOVETT, *supra* note 135, at 414; *see also* Fran Hawthorne, *The Other Retirement Crisis*, INSTITUTIONAL INVESTOR, Sept. 1998, at 61.

[152] *See* 29 U.S.C. § 1132(a)(3), (5) (1998).

[153] Employee Retirement Income Security Act of 1974, section 514(a), 29 U.S.C. § 1144 (1999), states that ERISA supersedes "any and all state laws insofar as they may now or hereafter relate to an employee benefit plan." *Id.*

[154] *See, e.g.*, Pilot Life Ins. Co. v. Dedeaux, 481 U.S. 44, 52 (1987); Romney v. Lin, 94 F.3d 74, 78 (2d Cir. 1996). *But see* Heather M. Susac, Comment, Romney

A commentator on the sweeping preemption of state common law claims under ERISA observed that "Republican leaders cling to state rights when it is expedient – for instance, dismantling the national welfare system," but when it comes to claims under ERISA (in this case with respect to suits against health maintenance organizations), "Republican leaders in the Senate and House are stalwart defenders of federal power . . . ."[155] This same observation could be made about all financial regulation. Where business perceives that federal preemption will result in less regulation and less civil liability, it has been pushed successfully. However, there is no reason to assume that in a different political climate, the federal regulatory agencies that have benefited from such preemption in terms of increased regulatory authority will remain as reluctant to use their powers as they have been during a period of deregulation. Further, in response to economic crisis, and in particular the failure of financial institutions or intermediaries or the failure of state guaranty funds for creditors of failed institutions or intermediaries, Congress, whether Democratic or Republican, has been quick to put federal insurance schemes in place with concomitant federal regulation.

Social Security privatization will probably further this long term trend toward stronger federal regulation of financial intermediaries and preemption of remaining state regulation. Social Security is now a federal program. Privatization of Social Security will not solve the current funding problems of this program, but it will stave off efforts to increase Social Security benefits and worsen funding problems.[156] However, if an increasing proportion of retirement savings are in private investment accounts, responsible financial regulators will appreciate that unless accounts are prudently invested with financial intermediaries that are adequately regulated as to their capital adequacy, investment mismanagement or financial crisis will wreak havoc with the retirement expectations of a large num-

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v. Lin: *ERISA Preemption of Section 630 of New York's Business Corporation Law*, 71 ST. JOHN'S L. REV. 691 (1997).

[155] Jamie Court, *ERISA Makes for Odd Bedfellows*, NAT'L L.J., Aug. 24, 1998, at A19.

[156] *See The Perils of Privatisation*, ECONOMIST, Aug. 15, 1998, at 65.

ber of older people. Further, only the federal government has the power and financial resources to appropriately ensure the solvency of these retirement accounts.

B. *Federal Agency Consolidation*

Financial institutions in the United States are subject to a balkanized regulatory system involving numerous federal and state securities, commodities, banking and insurance regulators. Yet, the federal government provides lender-of-last-resort protection to all segments of the financial industry. Further, the nation's safety net is inconsistent and also overburdened.[157]

According to a recent report of the General Accounting Office,[158] although activities of large U.S. banks, securities firms and insurance companies have converged to a significant extent, firms in each of these sectors have different regulators and these regulators have different oversight purposes and regulatory requirements. For example, bank capital standards are designed with an eye toward maintaining bank safety and soundness and calculate capital on a going concern basis.[159] Since the FDIC insures bank depositors who lend capital to banks and are bank creditors, capital adequacy rules also are aimed at protecting deposit insurance funds.[160] In addition, bank regulators are concerned about the viability of the payments system controlling the money supply, funding the national debt and systemic risk. There are numerous conflicts among bank regulators (without regard to their conflicts with other financial regulators), in part because different regulators have different concerns and responsibilities.

Capital standards for securities broker-dealers and futures commission merchants are focused on protecting customers in the event of a broker-dealer or FCM failure and are calculated

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[157] *See* Arista & Schlesinger, *supra* note 138, at 497. The federal safety net includes deposit insurance, access to the Federal Reserve Board's discount window and the Federal Reserve Board's large dollar payment system. *See* Keith R. Fisher, *Reweaving the Safety Net: Bank Diversification into Securities and Insurance Activities*, 27 WAKE FOREST L. REV. 123, 131-32 (1992).

[158] *See* GAO, RISK-BASED CAPITAL, *supra* note 87.

[159] *See* GAO, RISK-BASED CAPITAL, *supra* note 87, at 5, 42-43.

[160] *See* GAO, RISK-BASED CAPITAL, *supra* note 87, at 5, 42-43.

on a liquidation basis.[161] SIPC insures the cash and fully-paid-for securities in brokerage customers' accounts, and commodities exchanges guarantee the obligations of FCMs and others for commodities futures contracts traded on exchanges. No agency is responsible for insuring the viability of unregistered firms engaged in off-exchange trading of derivatives. Further, the objective of securities regulation is to protect investors through full disclosure in order to encourage capital formation. Providing federal insurance against foolish investment decision-making would put the government, instead of the markets, in charge of determining what corporations deserve fresh capital. This is the crux of the dilemma that will face legislators and regulators if Social Security is privatized. How can retirees be guaranteed a pension if they are required to establish personal investment accounts and may then choose to invest in any type of financial vehicle either directly or through, for example, a mutual fund?

Open-end investment companies are regulated to ensure that their shares are redeemable on a daily basis, but there is no federal insurance program to pay off fund holders if this proves impossible. Further, the need to have cash available to pay off mutual fund shareholders has contributed to market volatility and exacerbated stock market declines.[162] Investment advisers are relatively lightly regulated and are not subject to capital requirements.

Capital standards for life insurance companies are designed to ensure the long term viability of firms and to protect policyholders, and capital is calculated on a going concern basis.[163] Since many insurers are mutual companies, insurance rate regulation has been designed to keep insurance rates low rather than to generate a profit for insurers. As insurance companies demutualize and merge with other financial institutions, this focus will necessarily shift. Hopefully, the result will not be similar to the savings and loan debacle which resulted from S&L demutualization and deregulation.

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[161] *See* GAO, RISK-BASED CAPITAL, *supra* note 87, at 54-58.

[162] *See* E.S. Browning, *Industrials Dive 512.61 Points, or 6.37%; Tech-Stock Tumble Sinks Nasdaq Index*, WALL ST. J., Sept. 1, 1998, at C1; E.S. Browning, *Blue Chips Fall 45.06 Points in Volatile Trading*, WALL ST. J., Sept. 3, 1998, at C1; *see also* Solomon & Dicker, *supra* note 73, at 240-46.

[163] *See* GAO, RISK-BASED CAPITAL, *supra* note 87, at 64-67.

As financial institutions have become larger and more complex, their importance to the national economy increases. The bank regulators have a *de facto* too-big-to-fail policy. The SEC does not, but this has never been tested by the failure of a giant securities firm conglomerate.[164] If more retirement savings are held and disbursed by private financial institutions than by the Social Security Administration, what type of capital or financial adequacy rules will be necessary and appropriate to insure that funds held by financial institutions to pay pensions are forthcoming? This is a different issue than protecting investors against poor investment decisions. It is the problem the PBGC was created to solve for defined benefit retirement plans, but the PBGC does not insure defined contribution plans. This is already a serious problem, not addressed by existing federal legislation, and it will be greatly exaggerated by Social Security privatization.

The U.S. capital markets have been burdened with single industry regulation by diverse regulators, frequently quarreling instead of cooperating, for most of our economic history. At worst, this results in government sanctioned financial services cartels that are inefficient and anticompetitive.[165] At best, this system permits creative financial institutions to experiment with innovative new services on a scale that results in incremental rather than drastic change and permits regulators to engage in functional regulation that can be accommodated by the existing regulatory system.[166] Although the current system makes little regulatory or economic sense, it is politically expedient for the financial services industry, financial

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[164] *See* Kevin G. Salwen, *Review of Drexel Prompts SEC to Bolster Investigations of Financial Companies*, WALL ST. J., Sept. 11, 1990, at C9. Recently, the Federal Reserve Board intervened to prevent the failure of a large hedge fund, an entity not regulated by anyone. *See* Anita Raghavan & Mitchell Pacelle, *To the Rescue? A Hedge Fund Falters, So the Fed Persuades Big Banks to Ante Up*, WALL ST. J., Sept. 24, 1998, at A1.

[165] *See* Kenneth Scott, *The Uncertain Course of Bank Deregulation*, 5 REG. 40 (1981); *see also* Fisher, *supra* note 157, at 131.

[166] The SEC has long advocated functional regulation in response to legislative proposals to lift restraints on bank powers. *See* THE SEC SPEAKS IN 1997 480 (PLI Course Handbook Series B-980, Vol. 3, 1997). An exhaustive analysis of additions to bank regulatory powers that has resulted in the mixing of the insurance, securities and banking sectors despite the Glass-Steagall Act's separation of commercial and investment banking, 12 U.S.C. §§ 78, 377 and 378 (1998), is contained in Fisher, *supra* note 157.

regulators and Congress.[167] However, technology, globalization, and the institutionalization of capital markets have made this regulatory system obsolete, and sooner or later Congress will have to establish a more coherent and realistic regulatory system.

Privatization of Social Security would markedly increase the size of the private capital markets, probably increase rather than decrease institutionalization and, therefore, the volatility of those markets, and put an enormous strain on financial institutions and regulators. Continued conglomeration of financial services firms is one likely response to this strain. If this occurs, functional regulation is not an optimal solution to the ensuing regulatory challenges but can be only an interim or partial solution. Some financial regulator must be made responsible for monitoring the holding company parents of huge financial conglomerates. When banks began to form holding companies, the Federal Reserve Board was made the regulator of the large money center bank holding companies.[168] However, the SEC and CFTC have no authority to regulate the parent holding companies of brokers or FCMs.[169] Is the Federal Reserve Board, which has critical central bank functions, also the appropriate regulator for holding companies in the securities or insurance businesses? Should all financial futures and

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[167] A strong populist sentiment has contributed to the development of weak banks and a divided regulatory system. *See* Mark J. Roe, *A Political Theory of American Corporate Finance*, 1991 COLUM. L. REV. 10; Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L.J. 1927, 1948-49 (1993). Price fixing, blessed as rate making and the carving up of markets, has been an industry reaction. Single industry regulators are naturally reluctant to cede jurisdiction and power to other regulators, *see* Baranoff & Gattis, *supra* note 137, setting up a perfect scenario for the operation of public choice theory, which suggests that regulations will tend to favor (subsidize) relatively small and well organized groups that have a high per capita stake in regulations at the expense of large poorly organized groups. *See* SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 21-23 (1981). Since the financial regulators have, to some extent, different oversight committees in Congress, the power to oversee agencies and to extract PAC money from financial firms fearful of increased or new regulation has proven a powerful incentive to maintain the regulatory status quo. *See* Phil Kuntz, *Per Usual, Bank Bill Fails to Pass but Succeeds As Big Congressional Campaign Fund-Raiser*, WALL ST. J., Oct. 20, 1998, at A24.

[168] This was accomplished by the Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841-1850 (1994 & Supp. III 1997).

[169] *See* GAO, RISK-BASED CAPITAL, *supra* note 87, at 31.

securities be regulated by the same agency? Should insurance continue to be regulated by the states? Should the dual banking system be continued? The answer to such questions can be postponed only until there is a serious financial crisis that demonstrates the weaknesses of the current regulatory system. If Social Security savings are to be placed into the system, it will be better if these questions are addressed first.

III. INTERNATIONAL IMPLICATIONS

The privatization of key industries throughout the world, as economies shift from central planning and control to market driven capital formation, has led to significant improvements in financial regulation. This phenomenon is particularly apparent in Europe, at the individual country level and at the level of the European Union.[170] Privatization of retirement savings will accelerate this trend.

Nevertheless, the world and international financial regulators have a long way to go in providing investors with harmonized disclosure and corporate governance standards and secondary market transparency. Further, economic turmoil over the past year in Asia, Russia and other emerging markets have demonstrated not only the risks that downdrafts in foreign markets pose to U.S. financial institutions and investors, but also the havoc that U.S. investors can cause abroad.[171] International organizations do not exist to deal with these problems.

Better disclosure by corporate issuers has been addressed by the International Organization of Securities Commissions ("IOSCO"), but IOSCO is a voluntary organization of the world's securities regulators with no ability to make its recommendations mandatory.[172] Harmonization of international accounting standards has been progressing at the International

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[170] EU securities regulation initiatives are described in an article by Manning Gilbert Warren III. *The European Union's Investment Services Directive,* 15 U. PA. J. INT'L BUS. L. 181 (1994).

[171] *See* Anita Raghavan & Matt Murray, *Financial Firms Lose $8 Billion So Far,* WALL ST. J., Sept. 3, 1998, at A2; Michael R. Sesit & Sara Webb, *Wall Street Takes The Globe on a Wild Ride,* WALL ST. J., Sept. 2, 1998, at C1.

[172] *See* Roberta S. Karmel, *National Treatment, Harmonization and Mutual Recognition* 12 (Capital Markets Forum, Int'l Bar Ass'n, June 1993).

Accounting Standards Committee ("IASC"), but it is unclear whether such international standards will be accepted as authoritative by the SEC for filed SEC documents or the extent to which the IASC will compliment or supplant national accounting standard setters in the United States and elsewhere.[173] The European Union has harmonized disclosure in public offerings to some degree but has not moved forward on harmonization of accounting or corporate governance.[174] Further, although the European Central Bank will act as a financial regulator to some extent for countries in the European monetary Union, no securities regulator along the lines of the SEC has been established or contemplated.[175] Finally, while the United Kingdom is in the process of completely reregulating its financial markets through the establishment of a new super-regulator for all financial institutions, it is unclear how this new regulator will operate in London, let alone in coordination with foreign regulators.[176] The Asian financial crisis was triggered by a Japanese banking crisis caused by speculation on the part of Japanese financial firms and poor financial regulation.[177]

In Europe, universal banking is the norm, and even U.S. banks operating abroad follow this regime.[178] Accordingly, the primary and most effective international financial regulators are the Basle Committee and the Bank for International Settlements.[179] The problem of developing a global response to the supervision and regulation of financial conglomerates has been addressed in a limited way by the Basle Committee and IOSCO.[180] However, much more work needs to be done; tur-

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[173] *See* COOPERS & LYBRAND, UNDERSTANDING IAS xx-xiv (1996); *FASB in "Very Good" State, Jenkins Says,* 30 Sec. Reg. & L. Rep. (BNA) No. 7, at 251, 253-54 (Feb. 13, 1998).

[174] *See* BENN STEIL, THE EUROPEAN EQUITY MARKETS 147-81, 304-07 (1996).

[175] *See id.* at 134.

[176] *See* Richard Miles, *Giant Watchdog Will Take Time to Grow its Teeth,* TIMES (LONDON), Oct. 29, 1997, at 31; *FSA Must Wait For Powers,* TIMES (LONDON), June 1, 1998, at 48.

[177] *See* Edward J. Lincoln, *Japan's Financial Mess,* 77 FOREIGN AFF. 57 (1998); Satoru Murase, *Bankruptcy Attorney: Modern Day Samurai,* NAT'L L.J., Sept. 14, 1998, at C1.; Alan Reynolds, *Japan Should Cut Taxes to Spur Investment,* WALL ST. J., Sept. 11, 1998, at A14; Jathon Sapsford, *Japan's Plan for Banks Sinks Deeper In Debate,* WALL ST. J., Sept. 11, 1998, at A12.

[178] *See* Fisher, *supra* note 157, at 136-41.

[179] *See* GAO, RISK-BASED CAPITAL, *supra* note 87, at 8-9.

[180] *See* Joseph J. Norton & Christopher D. Olive, *Globalization of Financial*

moil in the financial markets has made this an urgent task. Prompted by the Asian crisis, the Bank for International Settlements determined to establish an advisory body to help governments draw up policies aimed at ensuring stability in their financial systems.[181] Further, repercussions from this financial crisis suggest that more widespread public support for dealing with instability in international financial markets and institutions may be forthcoming.[182]

The lack of harmonized standards for accounting, disclosure and corporate governance, the precarious condition of many foreign banks and financial institutions and the volatility in the international securities markets pose important issues to those who contemplate privatization of Social Security. Today, private pension plans are free to invest abroad and they do so.[183] If Social Security is privatized, will personal investment accounts be permitted such freedom? Such investments may increase returns, but it will also increase risks for these accounts, especially in view of the lack of transparency and liquidity in many foreign markets.

CONCLUSION

This Article has speculated about some of the regulatory reforms that might accompany or follow Social Security privatization, especially if such privatization takes a form that permits individuals to choose their own investments in a private investment account similar to current defined contribution plans. The SEC already is gearing up for more aggressive regulation. In a recent speech concerning Social Security privatization, the SEC Chairman stated that if such privatization

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Risks and International Supervision of Banks and Securities Firms: Lessons from the Barings Debacle, 30 INT'L LAW. 301 (1996); George A. Walker, *The Law of Financial Conglomerates: The Next Generation*, 30 INT'L LAW. 57, 71-72 (1996).

[181] *See BIS, Basle Group Set Up International Financial Stability Body*, 70 Banking Rep. (BNA) No. 11, at 450 (Mar. 16, 1998).

[182] *See Trade Union Advisory Committee Calls for Commission for Financial Market Regulation*, 70 Banking Rep. (BNA) No. 18, at 738 (May 4, 1998).

[183] Between one-quarter and one-half of defined benefit plans and about 5% of defined benefit plans invest more than 15% of their assets in international assets, and only about 13% of either type of plan shuns foreign holdings entirely. *See Globe-trotting*, INSTITUTIONAL INVESTOR, Mar. 1, 1998, at 181.

leads to self-directed individual accounts, "we must be ready to undertake an unprecedented level of broad-scale policing of the equity markets."[184]

The purpose of the Article has been to raise issues and provoke discussion rather than to argue for or against any particular form of Social Security privatization or any particular regulatory reform. Time and space constraints have made it necessary to paint an extremely complicated subject with a broad brush.

Yet, this Author's premise has been that Social Security privatization would be such a drastic economic and political change, that it could not take place in a vacuum. The government is inevitably the provider of last resort to those who cannot provide for themselves. Older citizens without resources will not be put out on the street to starve. Therefore, the government will have to ensure that Social Security funds invested otherwise than in government bonds is invested in honest businesses and not exposed to undue risk. This is a tricky business because too much government interference in the capital formation process would change the nature of capitalism.[185]

Further, if Social Security funds are invested in the public securities markets, whether by individual selection or in a constrained mode, there will have to be some assurance that the intermediaries involved are financially sound and that the funds are protected in the event of intermediary insolvency. Regulatory mechanisms to this effect are already in place today, but they are inconsistent as applied to different types of financial intermediaries. Moreover, if billions of new funds are channeled into the equity markets, this will have an impact on the markets and on financial intermediaries that is difficult to accurately predict. This Author's judgement is that the markets will become more institutionalized and more volatile and this will subject retirement savings to new risks that will have to be controlled in some way.

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[184] SEC Chairman Arthur Levitt, The SEC Perspective on Investing Social Security in the Stock Market, Address at the John F. Kennedy School of Government Forum 3 (Oct. 19, 1998) (transcript available at <http://www.sec.gov/news/speeches/spch223.htm>).

[185] *See id.* at 5.

Since the prospect of Social Security privatization is under discussion not only in the United States, but in many other countries, the problem of how to adjust financial regulation to accommodate such privatization is an international one. Further, unless Social Security funds are restricted against cross-border investment, regulatory inadequacies abroad will be felt in the United States.