

## THE SEC AFTER THE FINANCIAL MELTDOWN: SOCIAL CONTROL OVER FINANCE?

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2008 was not a good year for the Securities and Exchange Commission (SEC). In December, the revelation of Bernie Madoff's massive Ponzi scheme focused attention on the agency's failure to detect this long-running fleecing of investors.<sup>1</sup> In September, SEC Chairman Christopher Cox ended the Consolidated Supervised Entities Program after three of the investment banking firms in the program disappeared and the remaining two converted to bank holding company status. The change seemed to expose the SEC as a weak prudential regulator as compared to the Federal Reserve.<sup>2</sup> During the year, as various proposals for financial reforms swirled, it often seemed like the SEC was headed for the dustbin. The focus was on systemic risk and the consolidation of regulation which focused attention away from the SEC and

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1. Dianna B. Henriques & Zachary Kouwe, *Prominent Trader Accused of Defrauding Clients*, N.Y. TIMES, Dec. 11, 2008 available at <http://www.nytimes.com/2008/12/12/business/12scheme.html>.

2. See SEC Press Release, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm>. Bear Stearns had been sold to Morgan Stanley in March 2008 with the federal government providing a \$30 billion guaranty of Bear obligations. Lehman Brothers filed for bankruptcy in September 2008 after an unsuccessful search for buyers and government guarantees. During that same weekend, Merrill Lynch was sold to Bank of America in what was initially seen as a no cost transaction to the government, but which, by the end of 2008, led to billions of government bailout dollars for Bank of America. Shortly after the Lehman failure and Merrill sale, the remaining two investment banking firms, Goldman Sachs and Morgan Stanley, facing severe market pressures, converted to bank holding companies, which subjected them to regulation by the Federal Reserve, and perhaps more importantly, permitted them to borrow at the Fed's window. See generally DAVID WESSEL, *IN FED WE TRUST* (2009).

towards the Federal Reserve as the regulator of choice.<sup>3</sup> It looked like a game of musical chairs in which the SEC was slow to find its place.

While the agency achieved greater stability after President Obama's appointment of Mary Shapiro as Chair of the Commission, the turbulence in 2008 focused new attention on justifications for the agency's existence and where the agency has a relative advantage as a regulator. This article speaks to those questions, suggesting four core principles that should guide thinking about the agency's future in the aftermath of the financial meltdown. The first principle is what the SEC should not do: It should not be a prudential regulator, with a focus on systemic risk. Second, there remains a clear need for the role that the SEC has performed for 75 years as the principal government regulator of securities markets, the public companies whose securities are traded on those markets, and the various financial intermediaries who act in those markets. Third, the SEC should focus on its core characteristics as an independent agency that define its relative advantage as a regulator—its impartiality in performing a quasi-judicial role; its independence from the executive and legislative branches that enable it to avoid decision-making dominated by short-term interests; its expertise to regulate sophisticated transactions and a complex subject matter; and its ability to harness the knowledge and experience of the private sector. Fourth, the recent financial crisis has highlighted the role of the SEC as the vehicle for the government's control over the finance sector of the economy, a role which the SEC performed to a greater degree at its origin, but which has been less visible in recent decades. The essay discusses each of those principles in turn.

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3. Secretary of the Treasury Henry Paulson had begun a concerted effort for financial reform in 2006 shortly after taking office before the financial crisis was visible. He encouraged a study, chaired by Harvard Law Professor Hal Scott, but often called the Paulson Committee because of his support, to examine possible changes in federal regulation to keep American financial markets competitive in an increasingly globalized market. The Committee on Capital Markets Regulation, as it was formally called, issued an interim report in November 2006, available at <http://www.capmktreg.org/research.html>. Two other contemporaneous reports proposed reforms on similar topics. *See generally* Tomoe Murakami Tse, *Rules Harm U.S. Fiscal Markets, Report Says*, WASH. POST, Jan. 23, 2007, available at [http://www.washingtonpost.com/wp-dyn/content/article/2007/01/22/AR2007012201325\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2007/01/22/AR2007012201325_pf.html) (concerning the studies completed by the U.S. Chamber of Commerce and McKinsey & Co.). The Capital Markets Committee's time target to push reform in the period after the 2006 election slipped, but many of the ideas became the basis for a Treasury blueprint published in March 2008 just as Bear Stearns unraveled. *See* Press Release, Remarks by Secretary Henry M. Paulson on Blueprint for Regulatory Reform (Mar. 31, 2008), available at <http://www.treas.gov/press/releases/hp897.htm>.

## I. PRUDENTIAL REGULATION

Much of the public debate in the wake of the 2008 financial crisis focused on the failures of prudential regulation. With the innovation in financial products such as securitization and the use of hedging strategies, various financial participants found themselves exposed to serious losses as the economy slowed. High leverage and insufficient capital exacerbated the risk of financial failure of individual firms facing such losses. This, in turn, exposed other firms to instability as the failing firms could not deliver on positions taken in swaps and other transactions. As this level of exposure increased, firms became more reluctant to enter into transactions with some or many counterparties and extensions of credit froze across a broad spectrum of the economy.

The SEC has not traditionally focused on prudential regulation, leaving that role to banking regulators such as the Federal Reserve Board and various other regulators.<sup>4</sup> The SEC did not do particularly well with the Consolidated Supervised Entity Program, and it seems to lack a relative advantage in performing that role.<sup>5</sup>

The recent financial crisis exposed a pattern of companies exploiting the existence of multiple prudential regulators to avoid tighter government oversight and creating greater risk to the economy because such arbitrage can leave firms, their customers, and counterparties more vulnerable to financial failure. Questions of liquidity, leverage, and credit lock-up are best centralized in one regulator across the economy, or perhaps in a council of regulators. The recent experience has also revealed the need for such a regulator to have sufficient winding-up authority for firms that have failed.<sup>6</sup>

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4. This includes the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the regulator of credit unions. *See generally* Howell E. Jackson, *Variations in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. REG. 253 (2007) (identifying the American regulatory system as more fragmented and inefficient).

5. *But see* Erik R. Sirri, Remarks at the National Economists Club: Securities Markets and Regulatory Reform (Apr. 9, 2009), available at <http://www/sec.gov/news/speech/2009/spch040909ers.htm> (explaining the CSE “effectively added an additional layer of supervision at the holding company where none had existed previously.” SEC action in 2004 regarding broker-dealer net capital rules “has been unfairly characterized as being a major contributor to the current crisis” but the net capital rules alone could not limit the ability of the investment banks to undertake activities with the highest levels of inherent risk “outside of the US broker-dealer subsidiary.”).

6. *See, e.g.*, IN FED WE TRUST, *supra* note 2, at 24 (quoting an interview with former Secretary of the Treasury Henry Paulson and later emphasis of Fed chairman Ben Bernanke’s testimony and concluding “[t]he law didn’t provide a clean way for the government to take over or close an investment bank—no matter how important”).

The more difficult question is whether the agency that performs this regulation can be easily separated from the regulation of other functions within the same entity. Regulators in other countries have moved to a consolidated financial regulator, with mixed results.<sup>7</sup> Proposals for financial reform range over a spectrum that includes a twin peaks system or perhaps a triple peaked system, all considerably different from the hodgepodge of regulation in the current American system.<sup>8</sup> The next two parts of this essay argue that regulation of securities markets benefits from a focused securities regulator and that a securities regulator distinct from the prudential regulator has advantages in performing this job.

## II. THE SEC'S DISTINCTIVE CORE AS THE PRINCIPAL GOVERNMENTAL REGULATOR OF SECURITIES MARKETS, PUBLIC COMPANIES, AND INTERMEDIARIES

The regulatory function that the SEC has overseen for 75 years has covered three principal areas of regulation:<sup>9</sup>

1. Securities markets;<sup>10</sup>
2. The public companies whose shares are traded in those markets;<sup>11</sup>

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7. Twin-peaked refers to organizing government regulation by specific regulatory objectives, such as market conduct and prudential regulation. A triple-peaked model adds market stability as a third regulatory focus. See generally Howell E. Jackson, *Learning from Eddy, A Meditation Upon Organizational Reform of Financial Supervision in Europe* (Harvard Pub. Law. Working Paper Group, Paper No. 09-17, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1325510](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1325510).

8. *Id.*

9. As discussed in more detail in Part IV, on matters of internal corporate governance of public companies, the SEC is not the principal government regulator. State corporations law, and particularly the important corporate law jurisdiction of Delaware, creates corporations, define the key roles of shareholders, directors and officer, and provide the rules for corporate transactions such as electing directors and approving mergers. Federal securities law has long taken a supporting role in such decisions. The federal government has been the principal regulator as to disclosure discussed below, but over time the federal rules have been encroaching on more of the state law space, see for example Sarbanes-Oxley Act of 2002 as to the role of officers and shareholder access regulations discussed below. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15, 18, 28, and 29 U.S.C.).

10. See The Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (particularly section § 11A (15 U.S.C. § 77(k))).

11. This includes issuance of securities regulated by the Securities Act of 1933, 15 U.S.C. § 77a *et seq.* and periodic, proxy and tender offer disclosure relating to shareholders of such companies and some related substantive regulation as required by the Securities Exchange Act of 1934, 15 U.S.C. § 78(a) *et seq.* (hereinafter referred to by section numbers of the 1934 Act).

3. Various financial intermediaries who act in those markets (e.g. investment bankers,<sup>12</sup> broker-dealers,<sup>13</sup> investment advisers,<sup>14</sup> accountants,<sup>15</sup> lawyers,<sup>16</sup> mutual funds,<sup>17</sup> and others).

In regulating these markets, issuing companies, and intermediaries, the SEC performs several core functions. First, it provides a constitution-like structure for the markets, providing rules that private parties might themselves provide in the absence of government, while also shaping those rules in a way that the private parties might not.<sup>18</sup> Second, the securities statutes and the SEC regulations pursuant to them require a broad range of mandatory disclosures beyond what parties themselves, or stock exchanges on which company shares are listed, typically provide.<sup>19</sup> These disclosures permit investors to make more-informed decisions in purchasing or selling stock. In addition, they assist directors in performing their monitoring role under corporate law, permit other gatekeepers to more effectively perform a monitoring role, and generally increase the efficiency of the market in using information. Third, one of the most important functions provided by the SEC is enforcement: its officials police a broad range of behavior affecting investors from insider trading to inaccurate disclosure by companies to breaches of fiduciary duty by intermediaries.

Structuring social control over finance was a task that was central for the Roosevelt administration in its approach to legislation enacted in response to the Great Depression.<sup>20</sup> Some of the more far-reaching controls of the SEC,

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12. See notes 66–76 *infra*.

13. See § 15 of the 1934 Act.

14. See the Investment Advisers Act of 1940 Act, Pub. L. No. 38, 53 Stat. 1149 (1939) (codified at 15 U.S.C. §§ 77aa *et seq.*).

15. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15, 18, 28, and 29 U.S.C.).

16. Lawyers are not as extensively regulated as other participants. *But see* Sarbanes-Oxley Act of 2002, at § 307 (defining attorney obligations to report up); SEC v. National Student Marketing Corp., 457 F. Supp. 682 (D.D.C. 1978) (discussing possible attorney liability to stop a merger when learning of misleading disclosure); SEC Standards of Professional Conduct § 205.3(b), 17 C.F.R. § 201.205.5.

17. See generally Investment Company Act, 54 Stat. 789 (1940) (codified at 15 U.S.C. § 80a-1 *et seq.*).

18. See, e.g., Exchange Act Release No. 34-11203 (1975) (providing SEC rules banning fixed commissions). This SEC release was followed by congressional action. See Act of June 4, 1975, Pub. L. No. 94-29, 89 Stat. 97, 107–08 (1975) (amending the 1934 Act regarding the imposition of a schedule or fixed rate of commissions).

19. See, e.g., 17 C.F.R. §§ 229.10–229.1016 (concerning the core disclosure found in Regulation S-K).

20. See A.C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 VA. L. REV. 841 (2009).

such as those in public utilities and bankruptcy, have fallen away in the time since the New Deal.<sup>21</sup> A modern reader, conditioned to the disclosure-centric label of post-New Deal securities regulation, may fail to recognize the substantive changes from the financial world of the 1920s. But this function remains a part of the SEC repertoire. Examples such as the Sarbanes-Oxley regulation and changes proposed in the aftermath of the 2008 financial meltdown illustrate the continuity of this function as well. Part IV of this article treats this subject in greater detail.

### III. THE SEC'S RELATIVE ADVANTAGE AS AN INDEPENDENT GOVERNMENT AGENCY

The SEC's regulatory role, both historically, and what we should expect going forward, reflects the distinct benefits that come from being an independent government agency.<sup>22</sup> Independence, in this sense, means the freedom of action that derives from the fact that the President cannot remove its members and thereby directly affect policy.<sup>23</sup> The President nominates and the Senate confirms the five members of the agency, and the President can name the chair from among the five members.<sup>24</sup> The structure is intentionally designed to provide space for the agency to act independently of the chief executive. In contrast, for example, the Secretary of the Treasury, who serves at the pleasure of the President, is subject to immediate removal.<sup>25</sup>

Other characteristics of the agency add to its independence. It is not governed by a single administrator but rather by multi-headed group of five commissioners. No more than three of the five can be members of the same political party, and the commissioners serve staggered five-year terms, providing a regular infusion of new ideas.<sup>26</sup> In contrast to the cabinet

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21. See notes 75–76 *infra* and accompanying text.

22. This topic of this part is addressed in more in detail in Lisa S. Bressman & Robert B. Thompson, *The Future of Agency Independence*, 61 VAND. L. REV. (forthcoming 2010).

23. The SEC is not governed by a specific statutory removal restriction, unlike, for example, the Federal Reserve, whose members can be removed by the President only “for cause.” 12 U.S.C. § 242 (2006). But the President’s removal power is “commonly understood” as limited to “inefficiency, malfeasance in office, or neglect of duty.” *MFS Sec. Corp. v. SEC*, 380 F.3d 611, 619–20 (2d Cir. 2004) (quoting *SEC v. Blinder, Robinson & Co.*, 855 F.2d 677, 681 (10th Cir. 1988)).

24. The President has had the statutory right to appoint the chair since 1949 and was followed by custom for the prior period beginning with Franklin Roosevelt who designated Joseph P. Kennedy as the first chair, followed by James M. Landis, and then William O. Douglas when Landis left to be dean of the Harvard Law School.

25. *Humphrey's Ex'r v. United States*, 295 U.S. 602, 619 (1935).

26. 15 U.S.C. § 78d (2006).

departments where top leadership almost always changes with a change in administration, independent agencies such as the SEC provide a stronger dose of continuity.

The independent characteristics are not historical artifacts, but rather define the space within which the SEC continues to have a relative and distinct advantage as a regulator derived from the results that flow from independence. Four are discussed here: impartiality, avoiding short-term biases, expertise, and harnessing private parties.

*Impartiality.* The impartiality necessary to perform a quasi-judicial role in enforcement flows from independence. Like many other New Deal administrative agencies, the SEC sometimes performs a quasi-judicial function in ruling on whether a person's conduct has violated the provisions of the securities laws. Not only are there benefits to designing such a system in a nonpartisan way but there is a positive good in the political branches of the government not making the judicial-like decisions. This benefit of independence has been a staple of explanations about why we have independent agencies.<sup>27</sup>

*Avoiding Short-Termism.* Independence can be a way to avoid the harms of short-term decision-making if decisions were to be left to the executive or legislative branches. The best example of this is how monetary policy is set, particularly over the last several decades.<sup>28</sup> Interest rates and monetary policy are set not by the President or the Congress but by the Federal Reserve Board and the Federal Open Market Committee on which the Federal Reserve governors have a majority.<sup>29</sup> The seven Federal Reserve governors are

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27. This explanation may have been more prevalent in the early decades of the administrative state. See, e.g., 107 CONG. REC. 5847 (1961) (statement of President John F. Kennedy) ("This does not mean that either the President or the Congress should intrude or seek to intervene in those matters, which by law these agencies have to decide on the basis of open and recorded evidence, where they, like the judiciary, must determine independently, what conclusions will serve the public interest as that interest may be defined by law."). For some agencies, such as the NLRB, which has eschewed rule-making for most of its history, it is a more dominant explanation. See Catherine Fisk & Deborah C. Malamud, *The NLRB in Administrative Law Exile: Problems with its Structure and Function and Suggestions for Reform*, 58 DUKE L.J. 2013 (2009).

28. See ROBERT E. CUSHMAN, *THE INDEPENDENT REGULATORY COMMISSIONS* 4654–66 (1941) ("Some members of Congress, and the business interests supporting them, feared that the short-term incentives of Presidents would be to use monetary and banking policies for political or electoral benefit to the detriment of long-term economic stability and investment.").

29. The FOMC is a 12-person committee that includes the seven Federal Reserve governors and five presidents of the regional Federal Reserve banks. 12 U.S.C. § 263. These presidents in turn are chosen by the regional bank boards, made up of directors in three classes, two (bank and public members respectively) chosen by member banks and one chosen by the governors of the Federal Reserve Board. 12 U.S.C. §§ 304, 305. The FOMC decides questions such as the rate at which the Fed will lend to member banks. The Federal

appointed by the President and confirmed by the Senate for fourteen year terms and cannot be removed. While a president or legislators concerned about the next election could be expected to regularly err on the side of low interest rates even at the expense of creating runaway inflation, independent experts whose primary job is to set interest rates are more likely to find the appropriate balance.

Similar examples of using independence to avoid a harmful short-term bias can be found in securities and other areas. For example, the Public Company Accounting Oversight Board (PCAOB) is an independent entity, so as to insulate the auditor oversight function from the seemingly inevitable pressure from the regulated industry on those who are making those decisions.<sup>30</sup> Another example would be the BRAC approach to military base closure.<sup>31</sup>

*Expertise.* Independence can be a way to ensure or enhance the gains that would come from expertise as to the specialized and complex knowledge of markets and sophisticated financial transactions. This was a key explanation for the New Deal agencies in general,<sup>32</sup> somewhat discounted in the last two decades amidst concerns about accountability.<sup>33</sup>

*Harnessing the knowledge and expertise of the private sector.* A less-recognized benefit of independence is an agency's ability to access more effectively specialized knowledge and incentives of private firms in the regulated field. In a complex subject with many moving parts, an actor located within the industry possesses key knowledge needed for regulation, for example, detailed information of how an industry works, the incentives of those in the field, and where the abuses are likely to occur. Sometimes, important information is often only available as a byproduct of some other process, perhaps outside the regulatory reach but which would be known to one in the field.

It is not just specialized knowledge, however, that makes a regulatory agency's interface with the private participants potentially valuable. Much of

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Reserve decides questions such as how much capital to inject into the financial system.

30. See note 34 *infra*.

31. The Defense Base Closing and Realignment Commission (known as BRAC) in its most recent incarnation was authorized by National Defense Authorization Act for Fiscal Year 1991, Pub. L. No. 101-510, 104 Stat. 1485, 1496 (1991).

32. See MARVER H. BERNSTEIN, *REGULATING BUSINESS BY INDEPENDENT COMMISSION* 67 (1955) (quoting Speaker of the House Rep. Sam Rayburn as to why independent agencies are needed).

33. See Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2331-32 (2001) (describing centralized White House oversight and other presidential practices as enhancing accountability of executive branch agencies).



that information could be obtained by a detailed study of the field or by populating the regulatory agency with those with prior experience within the industry. A regulatory process that relies on self-regulation seeks to benefit as well from a greater willingness of private parties to participate in a regulatory system with some distance from the executive. This contributes a sense of ownership in the process for the private parties that is greater than would exist if the regulation came entirely from the government. Those within the industry have incentives to police their own, providing more effective regulation. When all in the industry can benefit by collective action, for example, to assure investors they will not be unfairly treated in markets, the actions of private participants may be more effective. They may understand the workings of the business in a way that those outside the industry do not. They may be able to insure compliance in ways that government regulators cannot. In working with a self-regulatory organization, an independent agency with a specific, defined focus may be better able to build a sense of professionalism than in a large government department. This may permit putting together a more competitive compensation package for employee regulators than would be possible if part of the regular government hiring process.<sup>34</sup> On the other side of the cost/benefit equation, self-regulation may facilitate shifting more of the costs of regulation from the government to the industry that should benefit from the regulation.<sup>35</sup>

This discussion of the benefits of incorporating private firms and incentives into regulation is not only a happy story. The greater role for private parties, and their greater willingness to participate in the process, also increases the possibility of industry capture of the regulators that has long worried commentators.<sup>36</sup> Indeed, that reality has led to a shift over time in the relative roles of industry and government in securities regulation in the direction of greater government control as discussed below. Any use of self-

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34. For example, presidents of the regional Federal Reserve banks receive salaries higher than the Secretary of the Treasury and members of the PCAOB receive salaries two to three times higher than the members of the SEC who appoint them. *See generally, e.g.,* Donna M. Nagy, *Playing Peekabo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1014–18 (2005). *See also id.* at 979 (summarizing the controversy over the disparity between salaries of PCAOB members and SEC commissioners).

35. There could also be cross-subsidization from a regulatory system that relies on a heavier dose of self-regulation as occurred prior to the mid-1990s when the existing pattern of higher bid-ask spreads for the Nasdaq market seems to have permitted more analysts information available about stock. *See* William G. Christie & Robert B. Thompson, *Wall Street Scandals: The Curative Effects of Law & Finance*, 84 WASH. U. L. REV. 1567, 1576 (2006).

36. *See, e.g.,* Jonathan Macey, *Administrative Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994).

regulatory organizations necessarily requires a consideration of both the costs and benefits of such a system as compared to alternatives systems that rely exclusively or mostly on government, or exclusively or mostly on markets. But securities regulation may provide one of the most detailed examples of where an independent government agency has been used to harness a wide array of participants from the industry to be regulated.<sup>37</sup> Consider the breadth of private actors incorporated within the SEC's regulatory web:

- Stock exchanges, such as the New York Stock Exchange and the NASDAQ stock market, determine rules for conduct in the trading of stock in those markets and listing standards for companies that seek to be listed on those exchanges. Long-time mutual firms owned by their members, stock exchanges have in the last decade become for-profit corporations owned by investors.<sup>38</sup> As self-regulatory organizations within the language of the Securities Exchange Act of 1934, the SEC approves their rule changes.<sup>39</sup> Pursuant to the congressional mandate in Section 11A of the 1934 Act, the SEC oversees the structure of the market in creating a national market for securities.<sup>40</sup>
- Disciplinary regulation of broker-dealers is handled today by the Financial Industry Regulatory Authority (FINRA), a 2006 successor to the work of the National Association of Securities Dealers and the regulatory functions previously performed by the New York Stock Exchange.<sup>41</sup> Like the exchanges, this is a private corporation outside the government, but rule-making and disciplinary action taken by FINRA are subject to review by the SEC.<sup>42</sup>
- Regulation of accountants and auditors incorporates two entities framed to nurture the participation of private parties. Accounting standards are developed by the Financial Accounting Standards

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37. See, e.g., JAMES COX ET AL., *SECURITIES REGULATION, CASES AND MATERIALS* 17 (6th ed. 2009) ("The Securities Exchange Act is unique to the extent it prescribes a co-operative regulatory effort by the SEC, and industry-sponsored groups called self-regulatory-organizations (SROs).").

38. NYSE, Timeline, [http://www.nyse.com/about/history/timeline\\_2000\\_Today\\_index.html](http://www.nyse.com/about/history/timeline_2000_Today_index.html) (describing the shift to public ownership.)

39. See § 15 of the 1934 Act.

40. Section 11A of the 1934 Act and Regulation SHO, 17 C.F.R. §§ 242.200 *et seq.*

41. See Exchange Act Release No. 34-56145, available at <http://sec.gov/rules/sro/nasd/2007/34-56145.pdf> (SEC Order approving bylaw amendment for NASD setting up the new governance structure of FINRA, with Board to include 11 public members, 10 industry members and the CEO).

42. See Exchange Act Release No. 34-56145, available at <http://sec.gov/rules/sro/nasd/2007/34-56145.pdf>.

Board (FASB), a five-member body, with members chosen for their expertise and independence, to which the SEC defers in the establishment of core accounting standards.<sup>43</sup> To discipline auditor performance, the Sarbanes Oxley Act of 2002 provided for the creation of an independent entity, the Public Company Accounting Oversight Board (PCAOB).<sup>44</sup> The statute specifies that the five-member board shall contain two (but not more than two) accountants and all five to be appointed by the SEC and subject to removal only for cause,<sup>45</sup> in an effort to provide independence from pressure from the major accounting firms.<sup>46</sup> That independence is combined with oversight by the SEC; all of its rulemaking and all of its enforcement actions must be approved by the SEC.<sup>47</sup>

- In the specific realm of municipal securities, Congress has provided for another board of experts, the Municipal Securities Rulemaking Board, but again the actions of this body are subject to the approval of the SEC.<sup>48</sup>

The field of securities regulation has a very densely populated set of self-regulatory organizations and other private actors. The pattern recurs in other fields but not to the same degree. One prominent example is the regional Federal Reserve Banks which are part of the central banking system. As discussed earlier, the regional banks provide five of the twelve members of the Federal Open Market Committee. The Committee determines core monetary policy in terms of setting interest rates at which the Federal Reserve lends to member banks.<sup>49</sup> Unlike the Federal Reserve governors who occupy seven slots on the FOMC, these regional presidents are not appointed by the

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43. The SEC, shortly after FASB's founding, issued a release stating "its intention its policy of looking to the private sector for leadership in establishing and improving accounting principles and standards through the FASB." Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Release No. AS-150, *available at* 1973 WL 149263 (SEC Release No. 150) (Dec. 20, 1973).

44. Congress provided for the PCAOB as a nonprofit corporation and that "the board shall not be an agency or establishment of the United States." 15 U.S.C. § 7217(b) (2006).

45. 15 U.S.C. § 7211(e)(6) (2006).

46. Senator Sarbanes, who gave a name to the statute that created the PCAOB, noted that "if we can structure the board well enough, it might actually have more independence from political influence than the SEC would have." *See Oversight Hearing on Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies Before the Senate Banking, Housing, and Urban Affairs Comm.*, 107th Cong. 657 (2002), at 1027.

47. 15 U.S.C. §§ 7217(b) & (c), 7219(b) (2006).

48. 15 U.S.C. § 78o-4.

49. *See supra* note 23 and accompanying text.

President and confirmed by the Senate. Rather, they are chosen by the boards of their regional bank, and two-thirds of the board members of those regional banks are chosen by the member banks within that particular geographic district.<sup>50</sup> The result is to provide a structure that brings private parties into a policy-setting apparatus.

Although the American system for securities regulation provides a plethora of illustrations of regulation by harnessing private parties, it is worth noting that there has been a distinct shift in securities regulation in recent years, enhancing the government's role in the regulation process at the expense of the "self" part of self-regulation.<sup>51</sup> For example, for decades after the enactment of the New Deal securities laws, broker-dealer regulation was performed, as described above within the umbrella of two "mutual" organizations owned by participants in the field, the New York Stock Exchange and the National Association of Securities Dealers. Enforcement was done by those in the business as part of the overall business. In the 1990s, separate scandals as to pricing practices on the NASDAQ and the NYSE led the SEC to push for governance reforms in both of those organizations in an effort to provide public control and break the direct control to those being regulated.<sup>52</sup> When FINRA was created in 2006 to succeed to the NYSE and NASD regulatory functions, the formal tie to the industry was cut.<sup>53</sup> The result was to move this regulation closer to the government regulation end of an industry/government spectrum.

Regulation of accountants and auditors has travelled along a similar road in which industry control of a self-regulatory system has, over time, given way to a process more within the government's domain. For decades after the appearance of federal securities laws, there was a peer-review based system to review possible auditor misconduct.<sup>54</sup> The system was revised several times over the decades leading to a byzantine and ineffective system.<sup>55</sup> In that space,

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50. 12 U.S.C. §§ 304, 305 (2006). The Federal Reserve governors name the remaining one third.

51. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 165 (2009) (reorganizations of NASD and NYSE "took much of the 'self' out of self-regulation").

52. See Christie & Thompson, *supra* note 35.

53. See Karmel, *supra* note 51.

54. See generally, e.g., Nagy, *supra* note 34 (describing the history of self regulation for accountants and auditors).

55. The SEC's leading historian, Joel Seligman, described the result as a "positively Byzantine structure of accounting disciplinary bodies which generally lacks adequate and assured financial support, clear and undivided responsibility for discipline, and an effective system of SEC oversight." *Oversight Hearings on Accounting Reform and Investor Protection Issues Raised by Enron and Other Public Companies Before the Senate Banking, Housing and Urban Affairs Committee*, 107th Cong. 532 (May 5,

Sarbanes-Oxley authorized the PCAOB, moving the auditor regulatory system from its peer-reviewed roots to one that relied more on a government function, albeit one housed in a nominally separate but SEC-controlled entity.<sup>56</sup>

Financial reforms proposed in the aftermath of the 2008 meltdown suggest this trend likely will continue with other actors in the financial services field. Hedge funds may be required to register and face other regulation.<sup>57</sup> Additional government control is likely for credit-rating agencies.<sup>58</sup> The convergence of broker-dealers and investment advisors has led to calls for parallel fiduciary duty standards for both sets of participants.<sup>59</sup>

The examples given in this part to illustrate the SEC's relative advantage as an independent agency in developing expertise and harnessing the private sector in pursuit of the regulatory goal relate almost entirely to the agency's performing two of the core functions identified at the beginning of this part—market regulation and oversight of the intermediaries who deal with investors. They illustrate a traditional strength of the agency, making use of its independence, and one that likely should continue in a stand-alone independent agency going forward. Part IV discusses the portion of the SEC's current agenda that fits outside of this template and which will depend on a somewhat different argument as to its purpose.

#### IV. REGULATION OF PUBLIC COMPANIES

Regulatory reforms after the meltdown have also included a set of proposals that focus on corporate governance more generally and not just on the markets and the intermediaries/gatekeepers in those markets. For example, the SEC proposed new rules to authorize shareholders to name nominees for director to be included on the corporation's proxy.<sup>60</sup> There has been a broad

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2002) (testimony of Joel Seligman).

56. The D.C. Circuit upheld the challenge to the PCAOB's unusual pedigree. *See* *Free Enterprise Fund v. PCAOB*, 557 F.3d 667 (D.C. Cir.) (2008), *cert. granted*, 129 S. Ct. 2378 (2009). The Supreme Court decision on the question was pending as this was written.

57. *House Panel Votes To Require Hedge Fund Registration*, [http://securities.law360.com/registrations/user\\_registration?article\\_id=130844&concurrency\\_check=false](http://securities.law360.com/registrations/user_registration?article_id=130844&concurrency_check=false) (reporting passage by the House Financial Services Committee on Oct. 27, 2009).

58. Annie Flaherty, *Credit Rating Agencies: New Regulations Approved By House Committee*, THE HUFFINGTON POST, available at [http://www.huffingtonpost.com/2009/10/28/credit-rating-agencies-ne\\_n\\_337450.html](http://www.huffingtonpost.com/2009/10/28/credit-rating-agencies-ne_n_337450.html) (reporting new regulation passed the House of Representatives Financial Services Committee on Oct. 28, 2009).

59. *See* Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439 (2010).

60. *See* Facilitating Shareholder Director Nominations, Exchange Act Release No. 33-9046 (June 10, 2009), available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>.

series of proposals to regulate executive compensation, some of which involve the SEC and others relating to other federal authorities. Shareholder “say on pay” (at least a precatory or advisory vote) was required for companies getting federal money and has been proposed for companies more generally.<sup>61</sup> The federal pay czar, empowered by explicit legislative direction as part of the federal relief to various industries under the TARP program, has sharply curtailed portions of the compensation and shifted the types of compensation for the twenty-five highest paid employees of the seven firms with federal ownership.<sup>62</sup> The Federal Reserve announced broad compensation guidelines for banks under its control that reflects discussions among the G-20 countries and the Financial Stability Board.<sup>63</sup>

These governance proposals raise a different set of concerns in terms of defining the SEC’s role going forward. The focus is on internal corporate governance—the appropriate role of managers and shareholders within the firm. Regulation on these topics makes less use of three of the independence characteristics discussed above—of impartiality, avoiding short termism and harnessing the private sector—than do the actions discussed in the previous section. The fourth characteristic, expertise, is surely visible, given the SEC’s detailed prior work on executive compensation and on the relative roles of shareholders vis-à-vis directors. But on these topics, the SEC does not have the only claim to governmental expertise. State law has a parallel claim to expertise as to regulating corporate governance. In Delaware, the state with the greatest share of incorporations, the legislature regularly updates its statutes following the recommendations of a standing committee of the Delaware state bar.<sup>64</sup> More relevant to the question of expertise, the Delaware judiciary, specifically the ten judges on the Court of Chancery and the Supreme Court, bring an expertise to questions of corporate governance across a docket that exposes them to more extensive and sophisticated corporate issues than the comparable experience and docket of the federal judiciary or

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61. Cari Tuna, *Investors Say “Yes” on Pay at TARP Firms*, WALL ST. J., Sept. 2, 2009, available at <http://online.wsj.com/article/SB125190043514279681.html>.

62. The Special Master for TARP Executive Compensation Issues First Rulings, available at <http://www.ustreas.gov/news/index1.html>.

63. Press Release, Bd. of Governors of the Fed. Reserve, Board Policy on Incentive Compensation (Oct. 22, 2009), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm>.

64. The Council of the Corporation Law Section of the Delaware Bar is responsible for recommending changes to Delaware’s General Corporation Law. See generally [http://dsba.org/sections/corporation\\_law.htm](http://dsba.org/sections/corporation_law.htm).

judges of any other state.<sup>65</sup> This sharing of expertise raises a federalism concern not present in the prior areas of SEC jurisdiction.

This part of the SEC's role illustrates a well-established but now orphaned SEC role of providing social control over finance. The origins of federal securities laws during the New Deal reflected the efforts of President Franklin Roosevelt and his administration to break the control of Wall Street over the nation's finances.<sup>66</sup> The 1933 Act inserted the FTC (and its successor, the SEC) between investment bankers and investors to protect investors in buying new issues, thereby diminishing the power of the investment bankers/underwriters.<sup>67</sup> The Securities Exchange Act of 1934 Act curbed the power of stock exchanges and their broker/dealer members as to transactions occurring over exchanges and in the over the counter markets.<sup>68</sup> A year later, the Public Utilities Holding Company Act of 1935 gave the SEC broad authority to refashion and structure the business practices of an entire industry that provided public utilities to large portions of the country.<sup>69</sup>

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65. The docket of the Delaware Chancery Court is 75% corporate cases, more than any other state in the country. The docket of the Supreme Court is about 35–40% corporate, again a percentage that no other state reaches. See Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 166 (2004).

66. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 19–20 (3d ed. 2003).

67. See, e.g., the comments of then-Professor (later Justice) William O. Douglas during the debate over the 1933 Act:

There is a need for some agency to step in between the persons who get the money and those who supply it and to fulfill the role of protector for the latter. . . . The ideal of "rugged individualism" when applied to investors has no longer any place in the program for American high finance.

Letter from then-Professor William O. Douglas, Yale Law School, to the Editor of *The New York Times*, Apr. 3, 1933, in FELIX FRANKFURTER COLLECTION, REEL 116. Later Professor Douglas turned more negative on the 1933 Act, regarding it as "of secondary importance in comprehensive program of social control over finance." William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171 (1933).

68. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 87, 99–100 (3d ed. 2003) (noting inclusion of stock exchange registration and proxy provisions which were the Roosevelt administration's first direct regulation of corporate governance, but noting the New York Stock Exchange had achieved "an almost total victory" regarding changes to rules regarding Exchange membership). William O. Douglas, as SEC chairman in 1937–1939, pushed the reform of the NYSE governance further leading to control of the exchange being transferred from the "old guard" to commission house brokers who regularly transacted business for the public. In the aftermath of the scandal involving former NYSE chair Richard Whitney, Douglas encouraged further reforms that increased the Exchange's disciplinary force, committing the exchange to more frequent and detailed audits of member firms and other reforms to protect investors in dealing with broker-dealers. See *id.* at 177–78 (describing the NYSE's adoption of a thirteen-point reform program on Oct. 26, 1938).

69. A far-reaching provision of the bill was Section 10, the "death penalty provision," which effectively limited a holding company to one geographic area and directed companies be broken-up under the direction of the SEC. See also Morris L. Forer, *A Postscript to the Administration of the Public Utility*

During FDR's second term, additional legislation broadened the government's reach over finance. The Chandler Act of 1938 gave the SEC a critical role in the reorganization of insolvent companies,<sup>70</sup> at the expense of investment bankers and high prestige law firms that dominated those deals in the pre-Act era.<sup>71</sup> The Trust Indenture Act of 1939 further supplanted investment banker control by limiting their ability to go outside of the reorganization process to gain contractual modifications for companies in distress.<sup>72</sup> The Investment Advisers Act of 1940<sup>73</sup> and the Investment Company Act of 1940<sup>74</sup> added control over investment advisers and mutual funds.

Over the next two decades this social control dissipated. The utility holding companies were liquidated and the Act was eventually repealed.<sup>75</sup> The SEC's central role in bankruptcies decreased as new processes matured so that by the 1970s Congress wrote the SEC's role out of the statute.<sup>76</sup> The government control over the key players in finance via the other statutes was taken for granted.

In the current context, government control is directed beyond the investment bankers or stock exchanges or lawyers to another group with control over finance—the managers of public companies. The control by managers was part of the concern of the 1930s.<sup>77</sup> But at that time, the federal

*Holding Company Act: The Hydro-Electric System Case*, 45 VA. L. REV. 1007, 1007–08 (1959) (PUHCA “was revolutionary in that it required not only the immediate eradication of specific and now all too familiar abuses, but also in that it provided for the minute supervision of actions and programs then conceived as being safely reposed in management.”).

70. Pub. L. No. 75-696, 52 Stat. 840 (1938). The bill required a trustee in every public company reorganization and that the reorganization plan as ultimately approved by the court had to be “fair and equitable.” To ensure that standard was met, the bill directed courts to solicit the SEC’s advice in reorganizations involving over \$3 million in debt, permitting its advice to be sought in smaller reorganizations. A reorganization branch of the SEC was established.

71. See DAVID A. SKEEL, JR., *DEBT’S DOMINION, A HISTORY OF BANKRUPTCY LAW IN AMERICA* 125 (2001) (“Within a few years, the starring role that the Wall Street Bankers had played for more than 50 years was a thing of the past.”). See also Robert T. Swaine, “*Democratization*” of *Corporate Reorganizations*, 38 COLUM. L. REV. 256, 259 (1938) (“In the name of ‘democratization’ corporate securityholders are to be enlisted in a war on corporate management. Not merely are bankers to be scourged from the temple, but corporate officers and directors are to be driven out with them.”).

72. 53 Stat. 1149–1178.

73. 15 U.S.C. §§ 80b-1 *et seq.* (2006).

74. 15 U.S.C. §§ 80a-1 *et seq.* (2006).

75. PUHCA was repealed in 2005. See Energy Policy Act of 2005, Pub. L. 109-58, 119 Stat. 594 (2005).

76. See SKEEL, *supra* note 71, for the story of this wind-down and William O. Douglas’s unintentional contribution to it.

77. See, e.g., Harlan Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8–9 (1934) (“The



government left core substantive regulation of managers to state law with federal law facilitating shareholder control over managers. The financial meltdown of 2008, the largest hit to our economy since the Great Depression that provoked the New Deal legislation, has spurred calls for additional regulation of what had been core state law questions of management such as executive compensation. The states could respond to this crisis, but they have not, just as they did nothing after the Enron crisis at the beginning of the decade.<sup>78</sup> The result is a likely expansion of the SEC's regulatory role deeper into the areas of traditional state concern.

#### CONCLUSION

The recriminations and debate that followed the financial meltdown of 2008 at first seemed to threaten the very foundations of the SEC's role as a regulator. In that respect, it is somewhat surprising that the agency now seems likely to come out of the reform debate intact and its role, particularly as to corporate managers, even enhanced. This Article suggests this turn of events can be explained by characteristics that flow from the SEC's status as an independent agency. Its impartiality, ability to avoid short termism, expertise, and harnessing of the private sector continue to give it a relative advantage as a regulator of modern securities markets. That part of the current debate that it does not fit as easily into this job description, increased control over corporate managers, reflects "social control over finance" that was a core part of the SEC's first decade and which has been reinvigorated in the wake of the worst financial crisis since that period.

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separateness of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, makes imperative a fresh and active devotion of [the principle that a man cannot serve two masters] if the modern world of business is to perform its proper function."').

78. Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 964 (2003) (asking "where were the states?").