

WILL THE SEC SURVIVE FINANCIAL REGULATORY REFORM?

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ABSTRACT

The Securities and Exchange Commission's ("SEC") conspicuous failures during the financial crisis of 2008 have led many to question the agency's relevance in the modern financial era. Some commentators have called for the creation of new super-agencies to assume a substantial portion of the SEC's duties. Others highlight enforcement failures and question the agency's commitment to its investor protection mission. Despite its recent missteps and persistent calls for regulatory overhaul, the SEC's future seems secure for now as President Obama's reform proposals (the "Obama Plan") as currently conceived preserve the agency's independence.

Although thus far the Obama Plan protects the SEC's status as an independent agency, several aspects of the plan threaten the agency's long-term prospects. The proposal to expand the executive branch's role in oversight over financial institutions may represent the beginning of an incremental encroachment on SEC authority. Similarly, the proposed Consumer Financial Protection Agency could absorb a portion of the SEC's traditional investor protection role. In the end, the SEC's survival depends on whether its leadership takes effective action to restore its credibility and regain the public trust in the years to come.

I. INTRODUCTION

The Securities and Exchange Commission ("SEC") is currently under siege. Its once stellar reputation has been tarnished by a series of inauspicious events that unfolded during the financial meltdown of 2008. The agency's passivity during the collapse of Bear Stearns, its failure to detect Bernard Madoff's massive fraud, and the failure of the Consolidated Supervised Entity program for financial conglomerates have led many to question the agency's competence and relevance in the era of modern globalized financial markets.¹

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1. For critiques of the SEC's actions prior to and during the financial crisis, see Norman S. Poser,

Even before the agency's recent mishaps came to light, its future was uncertain as reform advocates vigorously campaigned to rein in its powers. A sheaf of reports released in 2006 and 2007 recommended curtailing the agency's vast powers by creating new financial agencies or embracing broader industry self-regulation. Through proposed agency mergers, transfers of authority, and alternative regulatory methods, reform advocates sought to blunt the SEC's critical enforcement and oversight functions.

Despite these looming threats, sober analysis suggests that the SEC is destined to survive regulatory reform and will likely emerge as a stronger and more capable regulator. The Obama Administration's plan for financial reform (the "Obama Plan") resists calls for regulatory consolidation. If Congress adopts the Obama Plan's proposals, the SEC's authority over corporate governance, hedge funds, and over-the-counter derivatives will expand.² This expansion of SEC authority is an appropriate response to recent turmoil in the financial markets, as a strong and independent SEC remains a cornerstone of an effective financial regulatory regime.

II. ROOTS OF RECENT FAILURES

To intelligently assess the SEC's future we must first take stock of the factors that contributed to the agency's poor performance in the period leading up to and throughout the duration of the 2008 financial crisis. This section identifies the principal factors contributing to SEC malaise, which include external constraints on SEC authority, leadership failures, and a misplaced trust in financial institutions' ability to manage risk and safeguard the economy.

Why the SEC Failed: Regulators Against Regulation, 3 BROOK. J. CORP. FIN. & COM. L. 289 (2009); Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785 (2009). In addition, a slew of government reports have assessed the SEC's most glaring errors. See, e.g., U.S. SEC. & EXCH. COMM'N OFFICE OF INSPECTOR GEN., PROGRAM IMPROVEMENTS NEEDED WITHIN THE SEC'S DIVISION OF ENFORCEMENT (2009), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2009/467.pdf>; U.S. SEC. & EXCH. COMM'N OFFICE OF INSPECTOR GEN., INVESTIGATION OF THE FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME, PUBLIC VERSION (2009), available at <http://www.sec.gov/news/studies/2009/oig-509.pdf>; U.S. SEC. & EXCH. COMM'N OFFICE OF INSPECTOR GEN., RE-INVESTIGATION OF CLAIMS BY GARY AGUIRRE OF IMPROPER PREFERENTIAL TREATMENT AND RETALIATORY TERMINATION (2008), available at <http://finance.senate.gov/press/Gpress/2008/prg100708.pdf>.

2. As of this writing, the U.S. House of Representatives has passed a financial reform bill that largely reflects the proposals included in the Obama Plan. The Senate financial bill is still in the early stages of development, but in its current form it departs sharply from the model set forth in the Obama Plan and the House bill.

A. External Constraints

One factor that contributed to the SEC's recent failures is the erosion of its independence and authority at the hands of Congress and the courts.³ The cumulative impact of budgetary threats, pressure from Congress, and a series of adverse federal court decisions thwarted important SEC initiatives aimed at increasing oversight of financial firms, hedge funds, mutual funds, and auditors. These external constraints help explain the SEC's passivity in the face of the rapidly emerging 2008 financial crisis.

1. Congress

Part of the blame for the SEC's failures lies with Congress, which for the past few decades has pursued a deregulatory agenda that limited the SEC's power to address several of the major causes of the financial crisis. Broad legislative restrictions disabled the SEC from adequately overseeing the new financial conglomerates that financial deregulation had unleashed. Congress also banned the SEC and Commodities Futures Trading Commission ("CFTC") from regulating or monitoring transactions involving credit default swaps and other over-the-counter derivatives—another major contributor to the financial crisis. These statutory reforms left the SEC ill-equipped to address the principal causes of the 2008 credit crisis: financial firms' excessive risks, and the interconnectedness and interdependencies created by unregulated trading in credit default swaps.

Perhaps the most harmful legislative restriction on the SEC's authority was the Gramm-Leach-Bliley Act of 1999, which eliminated the traditional barrier between investment banking and commercial banks.⁴ This new law denied the SEC authority to oversee investment bank conglomerates, a power that may have equipped the agency to better control the systemic risks such firms posed for the economy. After Gramm-Leach-Bliley, the major U.S. investment banks became part of sprawling financial conglomerates that lay

3. For a more detailed discussion of how Congress and the courts have constrained SEC independence, see generally Renee M. Jones, *Legitimacy and Corporate Law: the Case for Regulatory Redundancy*, 86 WASH. U. L. REV. 1273 (2009).

4. Gramm-Leach-Bliley Financial Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified in scattered sections of 12, 15, 16 & 18 U.S.C.). For a more detailed discussion of the impact of Gramm-Leach-Bliley, see Renee M. Jones, *Back to Basics: Why Financial Regulatory Overhaul is Overrated*, 4 ENTREPRENEURIAL BUS. L.J. 391 (2010); see also Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 975–78 (2009).

beyond the SEC's regulatory grasp.⁵ Although the SEC retained authority over the broker-dealer subsidiaries of these firms, no regulator had power to police the entities as a whole. This gaping regulatory chasm eventually led the SEC to create the Consolidated Supervised Entity ("CSE") program for investment bank holding companies.⁶ Most observers, including former SEC Chairman Christopher Cox, have concluded in hindsight that the CSE program was a failure.⁷

The Commodity Futures Modernization Act of 2000 ("CFMA")⁸ also limited the SEC's ability to address the increasing importance of derivatives in the trading markets—another root cause of the financial crisis. Congress enacted the CFMA to block the CFTC from altering its treatment of over the counter ("OTC") derivatives, as its then-Chairman Brooksley Born had proposed.⁹ The CFMA forbids the CFTC and the SEC from regulating credit default swaps ("CDS") and other forms of OTC derivatives.¹⁰

After the CFMA, activity in CDS and other derivatives trading exploded.¹¹ This unregulated market was rife with problems, including poor documentation, lack of transparency and difficulties in assessing collateral adequacy and counterparty risk exposure.¹² The systemic risks created by unregulated trading in credit default swaps led to the downfall of Bear Stearns,

5. John C. Coffee & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 718 (2009).

6. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34428 (June 21, 2004) (codified at 17 C.F.R. pts. 200 and 240).

7. See Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt, and Risk*, N.Y. TIMES, Oct. 3, 2008, at A1; Poser, *supra* note 1, at 303; Press Release, Securities and Exchange Commission, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-30.htm> (Cox stated that the CSE program was fundamentally flawed because the SEC lacked authority to compel firms to comply with its guidance.); Coffee & Sale, *supra* note 5, at 736–46. But see Sirri *Defends Against Charges SEC Allowed Outsized Leverage at Firms*, 41 SEC. REG. & L. REP., at 651 (Apr. 13, 2009) (quoting Erik Sirri, the former director the SEC's Division of Market and Trading, as stating that SEC could not have prevented financial firms' failures due to limited powers prior to and under the CSE).

8. Pub. L. No. 106-554, 114 Stat. 2763, Appendix E (2000).

9. Rick Schmitt, *Prophet and Loss*, STANFORD MAGAZINE, Mar.-Apr. 2009, available at <http://www.stanfordalumni.org/news/magazine/2009/marapr/features/born.html> (describing CFTC Chairman Brooksley Born's unsuccessful battle against her Clinton administration counterparts to regulate trading in credit default swaps).

10. Pub. L. No. 106-554, 114 Stat. 2763, Appendix E (2000) (codified as CFMA §§ 103, 105, 302, 303).

11. David W. Porteous & James G. Martignon, *Credit Default Swaps: Regulatory Storm Clouds Brewing*, 40 SEC. REG. L. REP. (BNA), at 2070 (Dec. 15, 2008).

12. *Id.* See also DAVID WESSEL, IN FED WE TRUST 90–91 (2009) (describing the New York Federal Reserve's efforts to clear backlog in the documentation of CDSs).

Lehman Brothers, and AIG and threatened to destabilize the entire economy. With the benefit of hindsight, many key participants in the showdown with Chairman Born have come to regret the failure to regulate CDS in the 1990s.¹³

In addition to legislative constraints on SEC power, Congress employed indirect pressure to discourage the SEC from adopting regulatory policies that industry groups opposed. Perhaps the most vivid example of Congress's interference in financial regulatory matters occurred in 1993 when the Financial Accounting Standards Board ("FASB") with SEC support moved to adopt new accounting standards requiring corporations to expense employee stock options.¹⁴ The major audit firms and high tech industry leaders opposed this change to the accounting rules. They argued that option expensing would impose unreasonable burdens on start-up firms and weaken their ability to attract new talent. In response to political pressure, several congressmen, including Senator Joseph Lieberman, introduced bills to stop FASB from adopting the standard.¹⁵ Although FASB finally adopted its proposed accounting treatment in 2005, congressional pressure on the SEC and FASB created prolonged delays.

Members of Congress also resorted to budgetary threats in attempts to persuade the SEC to drop support for other new rules that lobbyists opposed. For example, when SEC Chairman Arthur Levitt proposed new rules for auditor independence, congressmen bombarded him with letters and phone calls opposing the initiative.¹⁶ This pressure caused Levitt to compromise on the proposal for fear of jeopardizing the agency's budgetary support.¹⁷

2. Federal Courts

In addition to congressional efforts to curb its authority, the SEC has faced debilitating wing-clipping at the hands of the federal courts. Two important new SEC rules were overturned by federal courts during the last decade. In *Goldstein v. SEC*,¹⁸ the D.C. Circuit Court rejected a new SEC rule

13. See *Frontline: The Warning*, transcript available at <http://www.pbs.org/wgbh/pages/frontline/warning/> (quoting Brooksley Born, Arthur Levitt and Gary Gensler).

14. See DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS 172–74 (2007); Gideon Mark, *Accounting Fraud: Pleading Scier of Auditors Under the PSLRA*, 39 CONN. L. REV. 1097 (2007).

15. ARTHUR LEVITT, TAKE ON THE STREET 236–43 (2002).

16. *Id.* at 130–39, 236–43.

17. *Id.* at 130–33 (describing corporate opposition to the SEC's proposed auditor independence rules).

18. *Goldstein v. SEC*, 451 F.3d 873 (2006).

that required hedge fund managers to register as investment advisers. If upheld, this rule would have allowed the SEC to gather information on hedge fund trading activities, which in turn may have equipped regulators to better perceive the systemic risks posed by CDSs.¹⁹

Likewise, in *Chamber of Commerce v. SEC*,²⁰ the D.C. Circuit Court twice rejected an SEC rule that required greater independence on mutual fund boards. In its first decision on the matter, the court ruled that the SEC had failed to adequately consider the costs of the new rule.²¹ The same court later rejected a re-promulgation of the same rule because the SEC had not allowed time for additional public comment.²²

The impact of adverse court decisions such as *Goldstein* and *Chamber of Commerce* extends beyond the rules they overturn. Such opinions have the more insidious effect of diminishing the SEC's regulatory vigor.²³ For fear of legal challenges, the agency adopts a more cautious stance and may avoid adopting new rules that promise to provoke controversy.²⁴ This phenomenon likely accounts for the SEC's current reticence to move forward on proxy access rules. The agency recently announced it would defer action on the access proposals preventing them from taking effect for the upcoming 2010 proxy season.²⁵

B. Mission Failure

Another factor in the SEC's weak response to the emerging financial crisis was inept leadership at the Commission. By all accounts, Chairman Cox was unusually passive as the large investment banks within his purview faltered.²⁶ The regulatory dormancy engendered by the Chairman's approach

19. Hedge funds were among the most active participants in the CDS market. U.S. GOV'T ACCOUNTABILITY OFFICE, HEDGE FUNDS: REGULATORS AND MARKET PARTICIPANTS ARE TAKING STEPS TO STRENGTHEN MARKET DISCIPLINE, BUT CONTINUED ATTENTION IS NEEDED (2008), available at <http://www.gao.gov/new.items/d08200.pdf>.

20. *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005); *Chamber of Commerce v. SEC*, 443 F.3d 890 (D.C. Cir. 2006).

21. *Chamber of Commerce*, 412 F.3d at 136.

22. *Chamber of Commerce*, 443 F.3d at 908.

23. For a broader discussion of the adverse impact of intrusive judicial review of agency rulemaking see Jones, *supra* note 3, at 1324–33 (describing the dangers of aggressive judicial review of SEC rulemaking).

24. *Id.*

25. Jesse Westbrook, *SEC to Delay Proxy-Access Rule, Giving Banks Reprieve*, BLOOMBERG.COM, <http://www.bloomberg.com/apps/news?pid=20601087&sid=a2ZCyme0W84Y>.

26. Kara Scannell & Susanne Craig, *SEC Chief under Fire as Fed Seeks Bigger Wall Street*

allowed problems in the financial markets to fester, eventually requiring urgent intervention by Treasury and the Federal Reserve.²⁷

1. Putting the Brakes on Rulemaking

Chairman Cox took office on the heels of his predecessor William Donaldson's attempts to complete a regulatory agenda formulated in response to the 2001–2002 governance scandals. Focal points of Donaldson's efforts were governance problems at operating companies, mutual funds, and within the hedge fund industry. Through litigation and litigation threats, corporate interest groups ultimately thwarted many of these regulatory initiatives.²⁸

Although Cox might have opted to pursue the regulatory agenda that Donaldson laid out, he instead adopted a decidedly passive stance on corporate governance reforms. The controversy surrounding shareholder proxy access that engulfed the agency in 2007 exemplifies Cox's reluctance to engage in proactive regulation.

The SEC took up the proxy access in early 2007, three years after Chairman Donaldson's efforts to forge SEC consensus on the issue had failed. Corporate governance activists had advocated for years, without success, for the right to access the corporate-funded proxy statement to propose shareholder nominees for a corporation's board of directors. After the Second Circuit Court of Appeals decision in *AFSCME v. SEC*,²⁹ the SEC revisited its position on proxy access. In *AFSCME v. SEC*,³⁰ the Second Circuit Court of Appeals rejected the SEC's interpretation of Rule 14a-8 to prevent shareholders from submitting proxy access bylaw amendments for inclusion in a company's proxy statement. The court found that by allowing companies to exclude such proposals that the SEC had reversed its earlier position without adequate explanation.³¹ The regulatory uncertainty that the *AFSCME* ruling created prompted the SEC to develop a proposal that would allow

Role—Cox Draws Criticism Low-Key Leadership During Bear Crisis, WALL ST. J., June 23, 2008, at A1; WESSEL, *supra* note 12, at 157 (describing federal regulators' decision to exclude Cox from discussions on the Bear Stearns rescue). According to Wessel's reporting, "top officials at both the Fed and the Treasury had decided the SEC and its Chairman weren't up to the job of coping with the collapse of an investment bank." *Id.*

27. Scannell & Craig, *supra* note 26; *see generally* WESSEL, *supra* note 12.

28. *See supra* text and discussion at note 23.

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

30. *Id.*

31. *Id.* at 129.

shareholders to use Rule 14a-8 to submit proposals to amend corporate bylaws to provide for proxy access.

While this proposal was under development, the staff produced an eleventh-hour alternative “no-access” proposal that restored the SEC’s pre-*AFSCME* position on the matter, prohibiting shareholder proposals that sought to impose proxy access. Chairman Cox supported this last-minute maneuver to release the “no-access” proposal alongside the proposal to permit shareholder access bylaws and he later cast the deciding vote on the Commission in favor of the “no-access” proposal.³²

Chairman Cox also let the clock run out on the SEC proposals to require greater independence on mutual fund boards after *Chamber of Commerce*, and chose not revisit hedge fund regulation after the court’s rebuke in *Goldstein*. This Cox-engendered passivity on corporate governance matters reduced the SEC’s relevance in financial oversight, leaving it to the Federal Reserve and the Treasury Department to step in to fill the void as the financial crisis unfolded.³³

2. Enforcement Division Missteps

Not only did Chairman Cox reverse course on governance reform, he also presided over the diminution in the stature and effectiveness of the SEC’s Division of Enforcement. In the post-Enron era, the SEC had become more aggressive in its enforcement practices, but retreated dramatically during Chairman Cox’s term. As the Government Accountability Office (GAO) noted, the aggregate amount of SEC penalties fell from \$1.59 billion in 2005 (the beginning of Chairman Cox’s term) to \$256 million in 2008.³⁴

Many suspect that new policies advanced by Cox contributed to this decline. In 2006, the Commission adopted a controversial policy that questioned the appropriateness of corporate-level penalties. Then, in 2007, the SEC initiated a “Pilot Program” requiring enforcement staff to consult with

32. See Securities and Exchange Commission, Shareholder Proposals, 72 Fed. Reg. 43466 (July 27, 2007); Securities and Exchange Commission, Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 43488 (July 27, 2007).

33. See generally WESSEL, *supra* note 12. IN FED WE TRUST is a chronicle of Chairman Bernanke’s and Secretary Paulson’s actions as the financial meltdown unfolded. Notable in his account is the absence of any significant action by Cox or the SEC during the failure of three major investment banking firms.

34. U.S. GOVERNMENT ACCOUNTABILITY OFFICE, SECURITIES AND EXCHANGE COMMISSION: GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN THE DIVISION OF ENFORCEMENT (2009), available at <http://www.gao.gov/new.items/d09358.pdf> [hereinafter GOVERNMENT ACCOUNTABILITY OFFICE].

the Commission before engaging in settlement discussions with corporate counsel.³⁵ The GAO concluded that these policies and practices caused the enforcement staff to retreat in its pursuit of corporate penalties due to the Commission's unwillingness to accept staff recommendations for such sanctions.³⁶ SEC chair Mary Schapiro abolished the Pilot Program in 2009, and pledged to work to address enforcement staff concerns regarding their autonomy and authority.³⁷

Another barrier to the Enforcement Division's effectiveness was a level of dysfunction that seems to have gripped the agency. Conflicts of interest, fear of powerful parties, and favoritism toward high-profile attorneys and their firms interfered with the Enforcement Division's impartial enforcement of securities laws.³⁸ As the SEC Inspector General has reported, the enforcement staff followed an ad hoc approach to following up on tips and in deciding when to initiate investigations or bring them to conclusion.³⁹ This ad hoc approach left enforcement attorneys vulnerable to manipulation and intimidation by their supervisors and by the targets of their investigations. The Inspector General's reports on Gary Agguire and the Madoff fraud, as well as the Enforcement Division generally, all support suspicions that a potential target's perceived clout can influence the outcome of SEC investigations.⁴⁰

35. DONNA NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT (2008).

36. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 34.

37. Mary L. Schapiro, Chairman, U.S. Securities and Exchange Comm'n, Address to Practising Law Institute's "SEC Speaks in 2009" Program (Feb. 6, 2009), available at <http://www.sec.gov/news/speech/2009/spch020609mls.htm>; *Testimony Before the Subcommittee on Financial Services and General Government*, 111th Cong. (June 2, 2009) (statement of Hon. Mary L. Schapiro, Chairman, U.S. Securities and Exchange Comm'n), available at <http://www.sec.gov/news/testimony/2009/ts060209mls.htm>.

38. See Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story* (Sept. 2009), available at <http://ssrn.com/abstract=1475433> (assessing the factors that led to the enforcement staff's ineffectiveness). See also Poser, *supra* note 1.

39. See Securities and Exchange Commission Office of Inspector General, Program Improvements Needed Within the SEC's Division of Enforcement (Sept. 29, 2009), available at <http://www.sec-oig.gov/Reports/AuditsInspections/2009/467.pdf>.

40. See Jones, *supra* note 3; see also James D. Cox & Randall S. Thomas, *Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of U.S. Securities Law*, 6 EUR. COMPANY & FIN. L. REV. 164 (Mar. 30, 2009), available at <http://ssrn.com/abstract=1370508> (providing empirical support for these suspicions); Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement against Broker-Dealers* (Aug. 11, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1333717.

3. Failure of the Self-Regulation Paradigm

No post-mortem on the SEC's recent mishaps would be complete without accounting for the failure of the SEC's Consolidated Supervised Entity ("CSE") program, which was adopted to fill a regulatory void created by the Gramm-Leach-Bliley Act. Under Gramm-Leach-Bliley, the SEC retained authority over the broker-dealer arms of these financial conglomerates, but no regulator had authority at the holding company level.

The lack of federal regulation at the holding company level created problems for these firms as the European Union's ("EU") Financial Conglomerates Directive of 2002 (the "Directive") required regulatory supervision of financial holding companies. The Directive exempted foreign firms from its regulatory rules as long as the firm was supervised by an EU-approved regulator. Thus, the large investment banks' freedom to do business in the EU depended on some form of holding company regulation.

The SEC and the large investment banks lobbied Congress to grant the SEC supervisory authority over large financial holding companies. After Congress declined to act, the firms persuaded the SEC to create the CSE program.⁴¹ The big five investment banks (at the time)—Bear Stearns, Merrill Lynch, Goldman Sachs, Lehman Brothers, and Morgan Stanley—joined the program, which was designed to function like the Federal Reserve's oversight of bank holding companies. The objective was to reduce the likelihood that weaknesses in holding companies would put regulated entities or the broader financial system at risk.

When the CSE program was terminated four years later, three of the five firms in the program had failed. Bear Stearns was sold to JPMorgan in a fire sale, Lehman Brothers filed for bankruptcy, and Merrill Lynch was snapped up by Bank of America to stave off its imminent collapse. Soon thereafter, the two surviving investment banks, Morgan Stanley and Goldman Sachs, opted out of the CSE program by electing bank holding company status and Federal Reserve supervision, after which the SEC officially abandoned the program.

One factor in the CSE program's failure was the reality that the CSE program was woefully understaffed.⁴² Only twenty-five SEC staff members were assigned to the program, with only three examiners for each of the five

41. Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, 69 Fed. Reg. 34428 (June 21, 2004).

42. SECURITIES AND EXCHANGE COMMISSION, OFFICE OF INSPECTOR GENERAL, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: THE CONSOLIDATED SUPERVISED ENTITY PROGRAM (Sept. 25, 2008), available at <http://www.sec.gov/about/oig/audit/2008/446-a.pdf>.

participating firms. The SEC's staff was overmatched by the firms' own internal risk specialists, and the SEC could neither closely monitor capital adequacy nor compel specific action to address identified risks.⁴³ Due to the voluntary nature of the program, staffers had to negotiate liquidity levels and leverage ratios with each firm, and the SEC's only recourse in the event of dispute was to threaten to ban the firm from participating in the program.⁴⁴

Another fundamental flaw in the CSE program was its misplaced faith in financial firms' ability to control risks despite the intense short-term incentives to embrace risk as a way of boosting profits. This program's faith in self-regulation and market discipline has been more broadly incorporated into financial regulatory policies. Gramm-Leach-Bliley and the CFMA both reflected regulators' judgment that market discipline was superior to government regulation when dealing with sophisticated financial actors. Former Federal Reserve chairman Alan Greenspan, perhaps the most ardent adherent to the tenets of market discipline, now counts himself among many recent converts who question the market's ability to solve complex problems of economic organization.⁴⁵

Chairman Cox has joined Greenspan in questioning the power of self-regulation. When announcing the suspension of the CSE program Cox noted, "the last six months have made it abundantly clear that voluntary regulation does not work."⁴⁶ Cox also conceded that the CSE program "was fundamentally flawed from the beginning, because investment banks could opt in or out of supervision voluntarily. The fact that investment bank holding companies could withdraw from this voluntary supervision at their discretion diminished the perceived mandate of the CSE program, and weakened its effectiveness."⁴⁷

III. THE ANTI-SEC CRUSADE

The SEC's own shortcomings are not the only threat to the agency's continued viability. Another pressing challenge is hostility to the agency that has flourished in the academic community for decades. Prominent

43. See Coffee & Sale, *supra* note 5, at 741–45.

44. SECURITIES AND EXCHANGE COMMISSION, OFFICE OF INSPECTOR GENERAL, *supra* note 42.

45. See Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES, Oct. 23, 2008, at B1.

46. Securities and Exchange Commission, 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>.

47. *Id.*

commentators have published articles and books in recent years that question the agency's legitimacy and advocate for its demise.⁴⁸ These views have penetrated policy circles and are reflected in several prominent reform proposals.

A. The Sarbanes-Oxley Backlash

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") created a host of new corporate governance restrictions and imposed new regulatory burdens on corporations.⁴⁹ Section 404, its most controversial provision, requires management to assess annually the effectiveness of internal controls over financial reporting and the independent auditor to attest to such assessments.⁵⁰ Initial Section 404 implementation costs were estimated to average \$4 million per issuer.⁵¹ These high compliance costs led many executives and commentators to criticize the provision.⁵²

In the aftermath of Sarbanes-Oxley, major U.S. business groups joined forces to build a case for rolling back the Act's most intrusive provisions and, more generally, to promote financial deregulation. The cornerstone of these efforts was the 2006 and 2007 release of three separate reports that presented a similar array of recommendations for regulatory reform. The most prominent of these reports was the Interim Report of the Committee on Capital Markets Regulation ("CCM Report"), which asserted that U.S. financial markets had lost competitive ground to foreign securities markets, and that this decline was

48. HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* (1979); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994); A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073 (2005). Although the SEC's academic critics have been vocal, other commentators have come to the agency's defense. See, e.g., Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 776 (2006); JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* (3d ed. 2003); Donald C. Langevoort, *The SEC as Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591 (2006).

49. 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.) (2006) [hereinafter Sarbanes-Oxley].

50. Sarbanes-Oxley § 404.

51. Robert A. Prentice, *Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404*, 29 CARDOZO L. REV. 703 (2007). A significant portion of these compliance costs is properly attributed to improvements in internal controls that firms needed but had deferred. The initial costs also included significant non-recurring ramp up costs. After initial implementation, Section 404 compliance costs declined 40 percent for large companies and 30 percent for smaller firms. See *id.*

52. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1251 (2005); HENRY N. BUTLER & LARRY E. RIBSTEIN, *THE SARBANES-OXLEY DEBACLE: WHAT WENT WRONG, HOW TO FIX IT* (2006).

due in part to onerous regulation in the U.S., most notably Sarbanes-Oxley and an overly intrusive SEC.⁵³

To restore U.S. markets to their proper pre-eminent position, the CCM Report recommended modifying the reach of Section 404, eliminating private securities regulation, and shifting from the SEC's command and control apparatus toward increased self regulation for the stock markets.⁵⁴ Many of these recommendations were echoed in reports published by the U.S. Chamber of Commerce⁵⁵ and a report from McKinsey and Company commissioned by New York Mayor Michael Bloomberg and Senator Charles Schumer.⁵⁶

B. Regulatory Reform Models

While only a loose connection exists between these Sarbanes-Oxley "backlash" advocates and proponents of financial regulatory overhaul, former Treasury Secretary Henry Paulson provides a crucial link. Early on, Secretary Paulson applauded CCM's efforts to assess Sarbanes-Oxley's impact on U.S. competitiveness. So closely was Secretary Paulson associated with the Committee on Capital Markets Regulation that the CCM Interim Report is frequently referred to simply as the "Paulson Committee Report."

In the spring of 2008, then-Secretary Paulson released the Treasury Department's "Blueprint for a Modernized Financial Regulatory Structure."⁵⁷ The Blueprint set forth a framework for restructuring financial regulation, which included plans to scale back and ultimately abolish the SEC. The Blueprint proposed eliminating (or shrinking) the SEC by dividing its powers between two newly created agencies and transferring a chunk of its authority

53. COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (Nov. 30, 2006).

54. *Id.*

55. U.S. CHAMBER OF COMMERCE, COMMISSION ON REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY: REPORT AND RECOMMENDATIONS (Mar. 2007), available at http://www.capitalmarketscommission.com/NR/rdonlyres/eozwwssfrqzdm3hd5siogqhp6h2ngxwdpr77qw2bogptzvi5weu6mmi4plfq6xic7kjonfpg4q2bpks6ryog5wwh5sc/0703capmarkets_full.pdf.

56. SUSTAINING NEW YORK'S AND THE U.S.'S GLOBAL FINANCIAL SERVICES LEADERSHIP (Jan. 2007). Some examples of Sarbanes-Oxley criticism that is present in the Bloomberg-Schumer report include the following quotes: "the flawed implementation of the 2002 Sarbanes-Oxley Act . . . has only aggravated the situation"; "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors"; "New York's decline in international capital raising is due to non-US-issuers concerns about compliance with Sarbanes-Oxley Section 404 and operating in what they see as a complex and unpredictable legal and regulatory environment." *Id.* at 12.

57. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (Mar. 2008).

to self-regulatory organizations, including the stock exchanges. In the shorter term, the Blueprint recommended that the SEC adopt the “principles-based” or “soft” regulatory approach employed by the CFTC and an eventual merger of the two agencies.

The Blueprint endorsed a structure advanced by the Twin Peaks model for financial regulatory reform, which calls for financial regulation to be organized around two principal objectives: prudential regulation and business conduct regulation.⁵⁸ Because the SEC mission neither falls squarely within nor fully occupies either peak, its role within a Twin Peaks structure is murky at best. In a pure Twin Peaks structure, the SEC’s current functions would likely be performed as part of a larger agency’s regulatory charge.

Another popular alternative to the Twin Peaks structure would also hasten the SEC’s demise. Some U.S. commentators have called for the creation of a universal regulator for all financial institutions modeled upon the U.K.’s recent financial reforms.⁵⁹ The universal regulator would have jurisdiction over all significant financial firms, with securities regulation comprising a mere subset of its duties. Although a version of the SEC might survive as a “division” of the universal regulator, its independence and authority would necessarily be diminished.

C. Consolidation Proposals May Destabilize the SEC

Advocates of regulatory restructuring have differing objectives than those who advocate for financial deregulation. Consolidation advocates frequently focus on questions of efficiency and regulatory effectiveness, while deregulators, by definition, disfavor mandatory regulatory standards. These distinctions tend to blur in the debate over regulatory reform as some overhaul proposals, most notably the Blueprint, combine restructuring and deregulatory proposals within a single package.

Regardless of their motivations, however, proponents of regulatory consolidation have the effect of destabilizing the SEC’s position within the regulatory fabric. Whether they aim to limit regulation or improve its

58. MICHAEL TAYLOR, “TWIN PEAKS”: A REGULATORY STRUCTURE FOR THE NEW CENTURY (Centre for the Study of Financial Innovation 1995) (on file with author).

59. See Howell E. Jackson, *A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States* (Harvard Law Sch. Pub. Law and Legal Theory Working Paper Series, Paper No. 09-19, 2008), available at <http://ssrn.com/abstract=1300431>; Elizabeth Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1 (2005).

effectiveness, most consolidation proposals would significantly alter the SEC's regulatory role. Because these proposals question both the capabilities and the necessity of a stand-alone SEC, they pose a grave risk to the SEC's survival.

IV. THE FUTURE OF THE SEC?—IT WILL SURVIVE

Although the decks were stacked against the SEC's future prominence when the financial crisis reached its nadir in the fall of 2008, at present, the SEC's prognosis is surprisingly strong. Rather than being subsumed or decimated as many advocates had proposed, the agency appears to be making efforts to reclaim its position as a premiere financial regulator.

The SEC's new leadership has renewed its commitment to a traditional investment protection mandate. On the rulemaking front, Chairman Mary Schapiro has picked up the baton where Chairman Donaldson left it, taking up proxy access, hedge fund regulation, and slowing momentum on the move to International Financial Reporting Standards ("IFRS") (one of Chairman Cox's favored projects). The SEC is likely to adopt some form of proxy access in 2010 and is moving to regulate hedge funds and derivatives with enhanced legislative authority from Congress.⁶⁰

Not only has SEC leadership committed to substantial governance reforms, the Enforcement Division is undergoing significant restructuring.⁶¹ Robert Khuzami, a former federal prosecutor, became the agency's new enforcement director in February 2009.⁶² Khuzami is reorganizing the division to increase the effectiveness and autonomy of line attorneys. Both Schapiro and Khuzami have pledged to take heed of criticisms from the GAO and Inspector General and are working to correct the problems revealed by their investigations.⁶³

60. SECURITIES AND EXCHANGE COMMISSION, FACILITATING SHAREHOLDER DIRECTOR NOMINATIONS, RELEASE NO. 33-9046, available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>; pending hedge fund and derivatives legislation; The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. §§ 3101 *et seq.*; 5001 *et seq.*; 7222 (1st Sess. 2009).

61. Jayne Barnard, *Evolutionary Enforcement at the Securities and Exchange Commission*, 71 U. PITT. L. REV. 403 (2010).

62. Zachary A. Goldfarb, *SEC Names Former Prosecutor as Enforcement Chief*, WASH. POST, Feb. 20, 2009, at D02. Khuzami spent 11 years as a prosecutor in the U.S. attorney's office for the Southern District of New York, and was chief of the office's securities and commodities fraud task force.

63. Mary L. Schapiro, Chairman, U.S. Securities and Exchange Commission, Address to Practising Law Institute's "SEC Speaks in 2009" Program (Feb. 6, 2009), available at <http://www.sec.gov/news/speech/2009/spch020609mls.htm>; *Testimony before the Subcommittee on Financial Services and General Government*, 111th Cong. (June 2, 2009) (statement of Hon. Mary L. Schapiro, Chairman, U.S. Securities

Despite these encouraging signals, the SEC faces continuing threats from regulatory reform. If the Obama Plan (as modified by the House) is enacted, the Financial Services Oversight Council's role as a systemic risk regulator might allow the Federal Reserve and Executive Branch agencies to eclipse the SEC as the primary securities market regulator. The proposed Consumer Financial Protection Agency ("CFPA") could also trample on the SEC's traditional terrain. If the CFPA emerges as an effective consumer advocate, it could conceivably absorb part of the SEC's investor protection role. The agency's survival depends to a large extent on whether it can restore credibility and public trust in the coming years.

V. CONCLUSION

The SEC's stature as a regulatory agency has suffered in recent years due to external constraints and its own internal failings. The financial collapse and pending reforms create an occasion to critically assess the agency's past and evaluate its prospects for the future. Despite its many problems, the SEC is likely to continue to play a pivotal role in financial regulation. Reform efforts should therefore focus on preserving broad SEC authority, ensuring strong leadership, and allocating resources commensurate to the agency's broad ranging responsibilities.

and Exchange Commission), *available at* www.sec.gov/news/testimony/2009/ts060209mls.htm.