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MERGING THE SEC AND CFTC—A CLASH OF CULTURES

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I. INTRODUCTION

The massive subprime losses at Citigroup, UBS, Bank of America, Wachovia, Washington Mutual, and other banks astounded the financial world. Equally shocking were the failures of Lehman Brothers, Merrill Lynch, and Bear Stearns. The conversion of Goldman Sachs and Morgan Stanley into bank holding companies left no large independent investment banks standing. If all that was not enough, Bernard Madoff's incredible $50 billion Ponzi scheme was a new milestone in the nation's financial history. Those failures and Madoff's fraud were unforeseen and undetected by the regulator, the Securities and Exchange Commission (SEC), which was responsible for overseeing the broker-dealers that failed and monitoring the investment advisers such as Madoff. That once-proud agency seemed helpless and hapless in the face of the subprime crisis, during which the investment banks it regulated lost hundreds of billions of dollars, threatening the entire economy.[1] Although those debacles touched the very core of the SEC's regulatory role, it appeared clueless of the risks that the country's largest and most venerable investment banks undertook in subprime-related transactions. The SEC was completely surprised by the failures of Bear Stearns and Lehman Brothers. It was equally surprised by the Madoff fraud, despite several warnings that Madoff's reported profits were unrealistic.[2]

The derivatives counterpart to the SEC, the Commodity Futures Trading Commission (CFTC), was also under fire from the press and

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1. Of course the investment banks were not the only ones reporting massive losses. The American International Group, Freddie Mac and Fannie Mae, homebuilders, and automakers were all posting massive losses that contributed to a panic in the markets and a declining economy. In addition to a damaged housing market, GDP dropped by 6.2% on an annualized basis in the fourth quarter of 2008, the sharpest drop since the recession in 1982. New unemployment claims were being filed at a rate of 600,000 per week in February 2009. Conor Dougherty & Kelly Evans, *Economy in Worst Fall Since '82*, WALL ST. J., Feb. 28, 2009, at A1. The unemployment rate in the United States reached 8.5% in March 2009. Floyd Norris, *U.S. Jobless Rate Likely to Pass Europe's*, N.Y. TIMES, May 23, 2009, at B3. The unemployment rate in California went above 11% in May 2009. Paul Krugman, *State of Paralysis*, N.Y. TIMES, May 25, 2009, at A19.

2. *See infra* notes 136–147 and accompanying text.

Congress in 2008 for its inability to control volatile commodity prices. Those price fluctuations were widely believed, without proof, to be caused by speculators acting with impunity in the commodity markets.[3] Prices exploded to $147.27 a barrel in 2008,[4] pushing gasoline prices to over $4 a gallon in July 2008,[5] before dropping back to about $37 in February 2009.[6] Widespread concerns were also raised about the transparency of the over-the-counter derivatives (OTC derivatives) markets that had been largely deregulated by the Commodity Futures Modernization Act of 2000.[7]

Some of the criticism of the SEC and CFTC is not justified. These two agencies were not responsible for the spike in commodity prices or the residential housing bubble. But the public has lost confidence in their ability to regulate markets because they have proved unable to deter or detect fraud. As the subprime crisis exploded, exposing the shortcomings of these agencies, the Treasury Department was considering its "Blueprint" for regulatory reform.[8] Among the Blueprint's wide-ranging proposals was a recommendation for combining the CFTC and SEC into a single financial services regulator.[9] This Article addresses that proposal.[10]

II. THE TREASURY BLUEPRINT

A. Competition Concerns

Responding to widespread concerns over overlapping and unnecessary regulation in the existing regulatory structure, then-Secretary of the Treasury Henry M. Paulson, Jr. launched an initiative in

3. *See infra* notes 255–73 and accompanying text.

4. *S&P 500 Drops Into Bear Market*, WASH. POST, July 13, 2008, at F6.

5. *Id.*

6. *Crude Oil Prices Fall Below $37 a Barrel*, N.Y. TIMES, Feb. 17, 2009, at B1.

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

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

9. TREASURY BLUEPRINT, *supra* note 8, at 106–11.

10. The author previously considered this issue in Jerry W. Markham, *Super-Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, Great Britain & Japan*, 28 BROOK. J. INT'L L. 319, 375–78 (2003) [hereinafter *Super-Regulator*]. Much water has passed over the dam since that article was published. The subject certainly deserves to be revisited in light of the Treasury Blueprint and the events that have unfolded during the subprime crisis.

October 2007 to consider how those concerns might be alleviated.[11] The backdrop for that study was a widely expressed concern that excessive regulation in the United States was undermining the nation's competitive position in the world. Before the subprime crisis reached its peak, even politicians normally in favor of regulation were advocating a roll back of at least some aspects of the Sarbanes-Oxley Corporate Reform Act of 2002 (SOX).[12]

New York Senator Charles Schumer coauthored an op-ed in the *Wall Street Journal* with New York City Mayor Michael Bloomberg that called for a study to determine if New York was losing its position as the world's leading financial center because of over-regulation and abusive shareholder litigation.[13] The resulting study stated that its findings were:

> [Q]uite clear: First, our regulatory framework is a thicket of complicated rules, rather than a streamlined set of commonly understood principles, as is the case in the United Kingdom and elsewhere. The flawed implementation of the 2002 Sarbanes-Oxley Act (SOX), which produced far heavier costs than expected, has only aggravated the situation, as has the continued requirement that foreign companies conform to U.S. accounting standards rather than the widely accepted—many would say superior—international standards. The time has come not only to re-examine implementation of SOX, but also to undertake broader reforms, using a principles-based approach to eliminate duplication and inefficiencies in our regulatory system. And we must do both while ensuring that we maintain our strong protections for investors and consumers.
>
> Second, the legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation. While nobody should attempt to discourage suits with merit, 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. In addition, the highly complex and fragmented nature of our legal system has led to a perception that penalties are arbitrary and unfair, a reputation that may be overblown, but nonetheless diminishes our attractiveness to international companies. To address this, we must consider legal reforms that will reduce spurious and meritless litigation and eliminate the perception of arbitrary justice, without eliminating meritorious actions.[14]

11. Request for Comments, Review by the Treasury Department of the Regulatory Structure Associated With Financial Institutions, 72 Fed. Reg. 58,939 (Oct. 17, 2007).

12. Pub. L. No. 107-204, 116 Stat.745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

13. Charles E. Schumer & Michael R. Bloomberg, *To Save New York, Learn From London*, WALL ST. J., Nov. 1, 2006, at A18.

14. MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US

Efforts to reform the reforms continued with a 2007 report from the blue ribbon Committee on Capital Markets Regulation (CCMR), which found that excessive regulation was hurting the securities markets and making foreign markets more competitive. The CCMR concluded that the United States' competitive position in financial services was "seriously eroding" and had "deteriorated significantly" in recent years.[15] The CCMR U.S. share of global initial public offerings (IPOs) by foreign companies also significantly declined between 1996 and 2007. In 2007, only about 10% of such foreign based IPOs were listed on a U.S. exchange, in contrast to 44.5% in 1996.[16]

In 1996, eight of the twenty largest global IPOs were listed on a U.S. exchange. In 2006, only one such offering was listed on a U.S. exchange, and foreign firms delisting from U.S. exchanges set a record that year. Statistics also evidenced that foreign firms were turning to unregulated private offerings when they sought to raise funds in the United States. IPOs by U.S. companies abroad also significantly increased.[17] The CCMR recommended that Congress decrease the burden of regulation and litigation in order to make the United States more competitive. The Committee predicted that within ten years, unless its recommended changes were made, the United States would no longer be the financial capital of the world.[18]

The U.S. Chamber of Commerce appointed a bipartisan, independent commission, which issued a report that also raised concerns with

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GLOBAL FINANCIAL SERVICES LEADERSHIP ii (2007).

15. COMM. ON CAPITAL MKTS. REGULATION, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET v, 1 (2007).

16. *Id.* at 1.

17. *Id.* at 2. Only 5% of the top 20 global initial public offerings in 2006 were listed in the United States, down from 60% five years earlier. The United States raised only 28% of global equity in 2006, down from 41% in 1995. *Hot Topic: Is Wall Street Losing Its Competitive Edge?*, WALL ST. J., Dec. 2, 2006, at A6. As Peter Wallison, a Fellow at the American Enterprise Institute, also noted:

> Between 1996 and 2001, the New York Stock Exchange averaged 50 new non-U.S. listings annually; in 2005, it was 19. In the same year, the London Stock Exchange, including its small company affiliate, the Alternative Investment Market, gained 139 new listings while Nasdaq attracted 19. Since the end of 2004, 30 foreign companies have left the NYSE and Nasdaq. Financial capital—the kind that finances mergers, acquisitions and new business formation—is also increasingly finding a more comfortable home abroad. Large offerings by Chinese, Korean and Russian companies—involving billions of dollars—have occurred in Hong Kong and London; meanwhile, large new foreign offerings this year by Russian aluminum producers and Kazakhstan oil and copper companies are planning to list in London.

Peter J. Wallison, *Capital Punishment*, WALL ST. J., Nov. 4, 2006, at A7. The number of foreign delistings increased to 56 in 2007, almost double that of the year before and over four times the amount in 1997. Editorial, *The Other Market Crisis*, WALL ST. J., Dec. 10, 2007, at A18.

18. COMM. ON CAPITAL MKTS. REGULATION, *supra* note 15.

unnecessary regulation. That commission found that "[i]n recent years, the U.S. has experienced a steady decline in its share of the global capital markets activity as international financial centers have grown to challenge this historical dominance."[19] Another report by the Financial Services Roundtable noted:

> Effective regulation and the competitiveness of U.S. financial markets and firms are vital to consumers, capital formation, job creation, and sustained economic growth. Consumers of all kinds—small savers, first-time homebuyers, college students, small businesses and medium-sized enterprises, large corporations, issuers, investors, pension funds, and even governments—benefit when markets are safe, stable, and secure as well as when they are vibrant and innovative, and financial services firms actively compete for their business. Today, financial services firms directly account for five percent of total US employment, and eight percent of U.S. gross domestic product (GDP).[20]

The Roundtable's report urged the adoption of principles-based regulation (as opposed to the current rules-based methodology) that would be risk-based, cost-effective, and standard across the same financial markets. The authors of the report included James Dimon, Chief Executive Officer of J.P. Morgan Chase, and Richard Kovacevich, Chairman of Wells Fargo—two banks that would be deeply involved in the subprime crisis as rescuers of failing institutions.[21]

B. Functional Regulation

Reform is sorely needed. The United Sates now operates under a "functional" regulatory system. Under this system, different regulators are appointed to regulate particular financial services, even if those services are offered by the same firm. This has resulted in much overlap and regulatory conflict, and created a system that failed to anticipate the subprime crisis. That the functional regulatory system failed should not be a surprise. It is a haphazard system of regulation that is not the result of a design or reasoned blueprint.[22] Rather, it is a set of accumulated

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19. COMM'N ON THE REGULATION OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 11 (2007).

20. FINANCIAL SERVS. ROUNDTABLE, THE BLUEPRINT FOR U.S. FINANCIAL COMPETITIVENESS 3 (2007).

21. *See id.*

22. The Treasury study was the first effort to undertake a comprehensive review of financial services regulation in the United States since the 1984 report by the Task Group on Regulation of Financial Services that was headed by then Vice President George H.W. Bush. Its members included Donald T. Regan, Treasury Secretary and former Merrill Lynch CEO, the chairman of the Federal Reserve Board, representatives from the Attorney General's office, the Office of Management and

responses to a long history of financial crises, scandals, happenstance, personalities, and compromises among a broad and competing array of industry and governmental bodies.[23]

Under functional regulation, financial service firms are regulated by fifty state insurance commissioners acting collectively through the National Association of Insurance Commissioners (NAIC), fifty state securities commissioners (plus the District of Columbia) acting collectively through the North American Securities Administrators Association (NASAA), fifty state attorneys general who operate in wolf packs when attacking financial service firms, and fifty state bank regulators. Union pension funds support that cast by acting as "private attorneys general" in bringing class action lawsuits whenever a company announces bad news.

At the federal level, functional regulators include the Federal Reserve Board (Fed), the Office of the Comptroller of the Currency in the Treasury Department (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), the Treasury Department's anti-money laundering group (FinCEN), and the Office of Foreign Asset Control (OFAC), which is also in the Treasury Department and handles financial embargoes imposed on troublesome countries. The Justice Department, together with the FBI and Postal Inspectors, has also become a financial services regulator by criminalizing bad corporate decision making. In addition, the SEC, CFTC, Federal Trade Commission (FTC), Occupational Safety & Health Agency (OSHA) (for SOX whistleblower claims), and self-regulatory bodies such as the Financial Industry Regulatory Authority (FINRA)

Budget, and the heads of several agencies responsible for regulating financial services. The Bush task force concluded that financial services in the United States were the "central nervous system of the economy" and that this industry was suffering from too much regulation. The Bush task force recommended reducing federal bank regulators from three to two, creating a new Federal Banking Agency in the Treasury Department and reducing financial services regulators. U.S. TASK GROUP ON REGULATION OF FIN. SERVS. BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 8 (1984). Those recommendations were not implemented. Instead, in 1999, Congress embraced "functional" regulation in the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 7, 11, 12, 15, 16 U.S.C.), which repealed the provisions of the Glass-Steagall Act, ch. 89, 48 Stat. 162 (1933). *See* LISA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANKING FINANCIAL SERVICE ACTIVITIES, CASES AND MATERIALS 239–40 (3d edition 2008) (discussing functional regulation).

Still another study, this one entitled *Financial Institutions and the Nation's Economy* (FINE), was undertaken by the House Committee on Banking Currency and Housing in 1975. FINE recommended that all depository institutions be regulated by a single regulator, a recommendation ahead of its time. *See generally Financial Institutions and the Nation's Economy (Fine) "Discussion Principles": Hearings Before the H. Subcomm. on Fin. Insts. Supervision, Regulation & Ins. of the Comm. on Banking, Currency & Hous.*, 94th Cong. (1975).

23. *In re* Methyl Tertiary Butyl Ether ("MTBE") Prods. Liability Litig., 559 F. Supp. 2d 424, 436 n.75 (S.D.N.Y. 2008) (quoting the author).

and National Futures Association (NFA) regulate various aspects of the financial services industry.

C. Treasury Report

In 2006, Treasury Secretary Paulson warned that the country was "creating a thicket of regulation that impedes competitiveness."[24] The Treasury Department sought public comment on regulatory efficiency issues in its study on the flaws in functional regulation. Of particular interest was the Department's request for comment on whether the "increasing convergence of products across the traditional 'functional' regulatory lines of banking, insurance, securities, and futures" justifies changes in the regulatory system to ensure that regulatory boundary lines do not unnecessarily inhibit competition.[25] The Department received more than 350 letters in response, indicating the financial community's interest.[26] The Treasury Department published its report in March 2008 (Treasury Blueprint).[27]

The study that led to the Treasury Blueprint was commenced at a time when inefficient regulation was thought to be impairing financial services. Even while the Treasury study was ongoing, however, a sea change was occurring as the subprime crisis arose and intensified. The *Wall Street Journal* declared in a front-page article on March 24, 2008, that a new era of increased regulation could be expected due to problems in the subprime market.[28] The Treasury Blueprint, which recommended a broad restructuring of the chaotic financial services regulatory structure, was published a few days after the *Wall Street Journal* article.[29] It sought more centralized and rational regulation because of concern that functional regulation was ineffective and was undermining America's traditional competitive advantage in financial services.[30] The

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24. Deborah Solomon, *Treasury's Paulson Warns of the Costs of Rules Overlap*, WALL ST. J., Nov. 21, 2006, at A2.

25. Request for Comments, Review by the Treasury Department of the Regulatory Structure Associated With Financial Institutions, 72 Fed. Reg. 58,939, 58,940 (Oct. 17, 2007).

26. David G. Nason, U.S. Treasury Assistant Sec'y for Fin. Insts., Remarks Before the City of London Corporation: Redesigning U.S. Financial Regulation for a Global Marketplace (Dec. 11, 2007), *available at* http://www.treas.gov/press/releases/hp726.htm.

27. *See* TREASURY BLUEPRINT, *supra* note 8.

28. Elizabeth Williamson, *Political Pendulum Swings Toward Stricter Regulation*, WALL ST. J. Mar. 24, 2008, at A1.

29. TREASURY BLUEPRINT, *supra* note 8.

30. The Blueprint noted:

> Due to its sheer dominance in the global capital markets, the U.S. financial services industry for decades has been able to manage the inefficiencies in its regulatory structure and still maintain its leadership position. Now, however, maturing foreign financial

Treasury Blueprint prophetically found that functional regulation:

> exhibit[ed] several inadequacies, the most significant being the fact that no single regulator possesses all of the information and authority necessary to monitor systemic risk, or the potential that events associated with financial institutions may trigger broad dislocation or a series of defaults that affect the financial system so significantly that the real economy is adversely affected.[31]

The Blueprint contrasted the functional regulatory approach in America with regulatory mechanisms abroad. England, Germany, Japan, and dozens of other countries use a single consolidated regulator, along with a central bank, to regulate; those countries eschew the "rules-based" approach used by most of the most regulators in the United States.[32] Rather, foreign regulators use a "principles-based" approach that sets broad regulatory goals and permits the industry to decide how to meet those goals. A principles-based approach reduces the need for volumes of regulations that seek to control every aspect of financial services operations—which is the approach taken by the SEC. The SEC has an institutional culture that seeks to dictate every aspect of corporate behavior. In contrast, the CFTC administers a principles-based regulatory structure put in place by the Commodity Futures Modernization Act of 2000.[33]

D. The Financial Services Authority

Before the subprime crisis, the Financial Services Authority (FSA), Great Britain's single regulator, was a model for regulatory agencies around the world. That agency was created after earlier regulatory reform efforts in London failed.[34] The FSA was given regulatory authority over all financial services in the U.K., and in the process, assumed the duties of nine other regulatory bodies. In so doing, Great Britain abolished self-regulatory organizations.[35] Among other things,

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> markets and their ability to provide alternate sources of capital and financial innovation in a more efficient and modern regulatory system are pressuring the U.S. financial services industry and its regulatory structure.

TREASURY BLUEPRINT, *supra* note 8, at 2.

31. *Id.* at 4.

32. *Id.* at 141.

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

34. For a description of the background that led to the creation of the FSA, see *Super-Regulator*, *supra* note 10 , at 375–78.

35. The FSA was a mixture of private and government initiative:

> The Financial Services Authority (FSA) is an independent non-governmental body, given

the FSA consolidated six separate insurance funds for compensating investors who suffer losses from failed financial institutions into one.[36] The FSA also merged fourteen separate rulebooks governing various financial activities into one.[37]

The single rulebook approach taken by the FSA was appealing, at least compared with the multitude of regulators in the United States. FSA regulation, at least initially, appeared successful. Despite the reduced regulation under the FSA, Great Britain was spared the Enron-era scandals that occurred under functional regulation in the United States. Critics contended that the FSA was understaffed and remained a weak regulator that deferred to the industry. Critics also argued that FSA unified regulations still imposed significant costs. Indeed, principles-based regulation under the FSA still required many rules, and the FSA handbook, which consolidated the rulebooks of earlier regulators, still totaled more than 8,000 pages.[38]

The FSA also had controversial powers. It could veto decisions by large financial institutions to hire executives with "significant influence." The FSA also had authority to monitor the performance of such executives through regular reviews and was authorized to require an executive be fired if its appraisal was negative.[39] Additionally, the FSA interviewed and approved hiring senior executives at "high-impact" firms.[40] This meant, of course, that financial institutions had to kowtow to their regulators because if, for any reason, they displeased the FSA, their executives could be fired.

A favorable impression of FSA regulation was created after it adopted

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> statutory powers by the Financial Services and Markets Act 2000. We are a company limited by guarantee and financed by the financial services industry. The Treasury appoints the FSA Board, which currently consists of a Chairman, a Chief Executive Officer, two Managing Directors, and ten non-executive directors (including a lead non-executive member, the Deputy Chairman). This Board sets our overall policy, but day-to-day decisions and management of the staff are the responsibility of the Executive.

Fin. Servs. Auth., Who are we, http://www.fsa.gov.uk/Pages/About/Who/index.shtml (last visited Feb. 19, 2010).

36. FIN. SERVS. AUTH., INTRODUCTION TO THE FINANCIAL SERVICES AUTHORITY 18 (2001), *available at* http://www.fsa.gov.uk/pubs/other/fsa_intro.pdf.

37. *Super-Regulator, supra* note 10, at 379–80.

38. 23 JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW: FINANCIAL RESPONSIBILITIES, CREDIT REGULATION, AND CUSTOMER PROTECTION § 2A:10 (2009).

39. Fin. Servs. Auth., FSA consults on changes to the rules for approved persons, http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/153.shtml (last visited on January 9, 2009).

40. Fin. Servs. Auth., Approved persons and appointed representatives, http://www.fsa.gov.uk/pages/Doing/Regulated/Approved/index.shtml (last visited on January 9, 2009).

a unified approach to capital requirements and risk management.[41] That program, however, proved to be an empty shell during the subprime crisis in 2007. The FSA was also strongly criticized for failing to prevent a bank run on Northern Rock PLC during the subprime crisis, the first run on a bank in England in more than 100 years. The English government nationalized that bank and put up $30 billion to rescue it and stop the panic.[42] The British government also rescued the Royal Bank of Scotland and Lloyds at a tremendous cost.[43]

After that series of events, Great Britain sought to enhance the FSA's powers and to make its regulation more intrusive.[44] In January 2008, the House of Commons Treasury Committee issued a report criticizing the FSA for its laxness in regulating Northern Rock. The report asserted that the FSA failed to allocate sufficient resources to monitor the bank whose "business model was so clearly an outlier."[45] The committee recommended that the Bank of England be the lead regulator when a bank faces financial difficulties. That recommendation was an apparent effort to turn back the clock on the single regulator concept, which had given the Bank of England's regulatory authority to the FSA because of perceived inadequacies in the Bank of England's regulatory abilities.

The FSA promised more stringent regulation in March 2009. It head, Hector Sants, also vowed that London would no longer be friendly to the financial services industry and that he intended to take strong action to assure that the business community would be "frightened" of the FSA.[46] The FSA's proposals included a regulatory wish list of massively increased capital requirements for banks, and closer scrutiny of their business models, products, and compensation schemes; the FSA also

41. FIN. SERVS. AUTH., ORGANIZATIONAL SYSTEMS AND CONTROLS: COMMON PLATFORM FOR FIRMS (2006), *available at* http://www.fsa.gov.uk/pubs/cp/cp06_09.pdf.

42. Julie Werdigier, *A Nationalized Northern Rock Curtails Its Products as Deposits Surge*, N.Y. TIMES, Oct. 3, 2008 at C7.

43. Landon Thomas, Jr., *British Bank Adapts to Life On a Leash*, N.Y. TIMES, Feb. 6, 2009, at B1. The U.K. government effectively nationalized the Royal Bank of Scotland, which suffered the largest ever quarterly loss by any company in the history of the U.K. in 2008. Sara Schaefer Muñoz et al., *U.K., U.S. Expand Bank Rescue Bids*, WALL ST. J., Feb. 27, 2009, at A1.

44. Julia Werdigier, *Slump Could Mirror 1990s, British Regulator Says*, N.Y. TIMES, Aug. 22, 2008, at C7. Sir James Crosby, the deputy chairman of the FSA, was forced to resign on February 11, 2009 after it was revealed that he had ignored warnings from a the risk manager at HBOS PLC while employed as the chief executive officer of HBOS PLC. That bank was later bailed out by the British government. Sara Schaefer Muñoz, *Under Fire, a Top U.K. Watchdog Quits Post*, WALL ST. J., Feb. 12, 2009, at C3.

45. Richard Fletcher, *Forking out more to the financial regulator may not be money well spent*, DAILY TELEGRAPH (London), Oct. 18, 2008, at 31.

46. Peter Thal Larsen, *Gloves to Come Off as FSA Ends "Light Touch" Era*, FIN. TIMES (London), Mar. 13, 2009, at 17.

proposed regulation of credit rating agencies and hedge funds.[47] FSA chairman Lord Turner weighed in with a 122-page report in March 2009 that also advocated abandoning London's light-touch regulation. He wanted to impose restrictions that would limit excessive risks taken by banks through increased capital liquidity measures. Lord Turner also sought a pan-European regulatory body.[48]

Nonetheless, the single regulator concept was losing its luster. For example, a European Union panel considering structural changes in its financial services regulation in the wake of the subprime crisis did not seem interested in a single regulator.[49] The conservative party in the U.K. was also advocating a "twin peaks" regulatory approach that was also under consideration in the United States.[50]

E. Twin Peaks

In seeking to abandon functional regulation, the Treasury Blueprint did not advocate a single regulator system for the United States. The Blueprint rejected a single regulator model for many reasons:

> While the consolidated regulator approach can deliver a number of benefits, several potential problems also arise. First, housing all regulatory functions related to financial and consumer regulation in one entity may lead to varying degrees of focus on these key functions. Limited synergies in terms of regulation associated with financial and consumer protection may lead the regulator to focus more on one over the other. There may also be difficulties in allocating resources to these functions. Second, a consolidated regulatory approach to financial oversight might also lead to less market discipline as the same regulator would regulate all financial institutions, whether or not they have explicit government guarantees. This would seem to be particularly important in the United States where a number of financial institutions have access to explicit government guarantees of varying degrees. Third, since regulatory reform must consider the role of the central bank, the consolidated regulatory approach must maintain some degree of close coordination with the central bank if the central bank is going to be ultimately responsible for some aspect of market stability. The United Kingdom's recent experience with Northern Rock highlights the importance of this function in the consolidated regulator approach.

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47. Julia Werdigier, *British Regulator Takes a Tougher Line*, N.Y. TIMES, Mar. 19, 2009, at B8.

48. Peter Thal Larsen et al., *Turner to End Light-Touch Regulation*, FT.COM (Fin. Times), Mar. 18, 2009, *available at* http://www.ft.com/cms/s/0/68397782-13b7-11de-9e32-0000779fd2ac.html.

49. Alistair MacDonald, *Financial Regulatory System Gets Overhaul Suggestions*, WALL ST. J., Feb. 26, 2009, at A8.

50. Larsen, *supra* note 46, at 17.

> Finally, the scale of operations necessary to establish a single consolidated regulator in the United States could make the model more difficult to implement in comparison to other jurisdictions.[51]

Instead of a single regulator, the Blueprint recommended that the United States adopt the "twin peaks" approach used in Australia and the Netherlands.[52] This concept is attributed to Michael Taylor, a former official at the Bank of England who wrote a 1995 article entitled *'Twin Peaks': A Regulatory Structure for the New Century.*[53] The Twin Peaks approach is objectives-based and focuses on specific regulatory goals.

Twin Peaks envisions a central bank that focuses on prudential supervision, and a single business practices regulator that focuses on business conduct and consumer protection. From this the Treasury Blueprint created a "Three Peaks" approach that would have three separate bodies implementing three specific regulatory goals: (1) market stability regulation, (2) prudential financial regulation, and (3) business conduct regulation. This objectives-based approach would require consolidating and reshuffling the existing functional regulators in the United States into essentially three principal regulators. The market stability regulator would be the Federal Reserve Board. A new agency would be created for prudential financial regulation that would regulate financial institutions with a government guarantee, such as banks insured by the FDIC and broker-dealers insured by the Securities Investor Protection Corporation (SIPC). A new agency would also have to be created for the business conduct regulator, which would create and apply principles-based regulation.[54]

The Treasury Blueprint recommended that in the interim, the SEC and CFTC be merged. It also recommended that the SEC adopt a principles-based regulatory approach, like that of the CFTC, to make the merger more workable.[55] The Parts below discuss the many obstacles to such a merger. Prior efforts to merge the two agencies revealed strongly entrenched constituencies willing to battle to keep themselves separate, and a vast gulf in the two agencies' regulatory approaches, creating differing cultures that often clashed.

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51. TREASURY BLUEPRINT, *supra* note 8, at 141.

52. *Id.* at 139, 142.

53. Jill Treanor, *Regulators back Taylor's twin-peaks theory*, INDEPENDENT (London), Oct. 29, 1996, http://www.independent.co.uk/news/business/regulators-back-taylors-twinpeaks-theory-1360780.html.

54. TREASURY BLUEPRINT, *supra* note 8, at 144.

55. *Id.* at 106–11.

III. EFFECTS OF THE SUBPRIME CRISIS ON REGULATORY REFORM

A. The Need for Reform Grows

The Treasury Blueprint encountered much opposition and only mild support when it was published.[56] Among those opposing the Blueprint were the Consumer Federation of America and the Democratic leader of the Senate Finance Committee, Christopher Dodd of Connecticut.[57] The regulatory structure proposed by the Blueprint would also preempt most state regulation of financial institutions, which the states would not accept without a fight. After all, this would cut off the career paths of many budding state politicians who witnessed the rise of Eliot Spitzer as a result of his attacks on Wall Street.[58] Even now Spitzer's successor as New York's attorney general, Andrew Cuomo, is nationally known for taking on Wall Street by investigating the financial services industry, including student loans, auction rate securities, rating agencies, and even bonuses paid to Merrill Lynch executives.[59]

In November 2008, the NASAA announced its own plan for reform, which recommended preserving state regulation, but admitted that some streamlining might be in order. The NASAA advocated that all financial products and markets be subjected to regulation so that there would be no regulatory gaps. It was in favor of principles-based regulation, but only as an additional layer to existing rules. The NASAA also advocated tougher enforcement and stronger private remedies.[60] In other words, it wanted to make the present situation of both state and federal regulators—and their private attorneys general (such as labor unions)—even more intolerable.[61]

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56. The author attended a banking conference sponsored by the University of North Carolina law school shortly after the Blueprint was published. The General Counsel for Wachovia noted that Secretary Paulson had stated that the recommendations in the Blueprint were only "aspirational." The General Counsel stated that he looked that word up in the dictionary and that it appeared to be a derivative of the Latin term for "not a snowball's chance in hell." That was a fair assessment at the time. Subsequent events, however, have overtaken Wachovia and other skeptics on the need to effect regulatory reform.

57. David Cho et al., *Long Fight Ahead for Treasury Blueprint*, WASH. POST, Mar. 30, 2008, at A1.

58. I have described those events in JERRY W. MARKHAM, A FINANCIAL HISTORY OF MODERN U.S. CORPORATE SCANDALS: FROM ENRON TO REFORM *passim* (2005).

59. Amir Efrati & Aaron Lucchetti, *U.S. News: Cuomo Blazes Own Trail as Wall Street Cop*, WALL ST. J., Aug. 11, 2008, at A3; Michael J. de la Merced & Louise Story, *Nearly 700 at Merrill in Million-Dollar Club*, N.Y. TIMES, Feb. 12, 2009, at B1.

60. Press Release, N. Am. Sec. Adm'rs Assoc., NASAA to Host Financial Services Regulatory Reform Roundtable (Nov. 26, 2008), *available at* http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/9910.cfm.

61. The Treasury Blueprint also sought an optional federal charter for insurance companies that would preempt state law. Under the Treasury Blueprint, a federal Office of National Insurance would

States were supported by the Congressional Oversight Panel, which was created to oversee the $700 billion TARP bailout program that was implemented to rescue financial institutions during the subprime crisis. It recommended that states be given the power to regulate national bank lending practices—a power the Supreme Court had previously held was preempted by federal law.[62] The panel recommended that a single federal regulator be created to set minimum standards for consumer credit products, but permit the states to adopt more stringent requirements.[63]

The intensity of the subprime crisis assured that regulatory reform would be at the top of the new Obama Administration's to-do list. Even before Obama was sworn in, the Government Accountability Office (GAO) issued a January 8, 2009, report which warned that significant reforms were critically and urgently needed in the financial regulatory system. Like the Treasury Blueprint, the GAO report recognized that the financial structure was not the result of any grand design, but had been created on an ad hoc basis over the years in response to financial crises. The GAO concluded that the existing system was unable to mitigate systemic risks, had difficulty controlling unregulated market participants, failed to keep up with new and complex investments, and suffered from a fragmented oversight regimen.[64] The GAO issued a second report later that month calling for a major reform of the regulatory system that it again called "fragmented and outdated."[65]

President Obama appointed former Federal Reserve Board Chairman Paul Volcker as chairman of a new Economic Recovery Advisory Board, formed to advise the President on how to deal with the subprime crisis. That appointment raised hopes that a Twin Peaks approach might

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oversee these federally chartered insurance companies. TREASURY BLUEPRINT, *supra* note 8, at 128–33. This proposal was given some impetus by the failure of the American International Group, which received a $173 billion bailout by the federal government during the subprime crisis. Normally subdued Fed Chairman Ben Bernanke had some harsh words for AIG in testimony before Congress on March 3, 2009:

> AIG exploited a huge gap in the regulatory system. There was no oversight of the financial-products division. This was a hedge fund, basically, that was attached to a large and stable insurance company, made huge numbers of irresponsible bets, took huge losses. There was no regulatory oversight because there was a gap in the system.

Sudeep Reddy, *Bernanke Expresses Frustration Over AIG Rescue*, WALL ST. J., Mar. 4, 2009, at A2.

62. *See* Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007).

63. *Regulatory Reform: Oversight Panel Calls for Regulatory Reform, With Risk Regulation, More Power for States*, 41 Sec. Reg. & L. Rep. (BNA) 155 (Feb. 2, 2009).

64. U.S. GOV'T ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM (2009).

65. U.S. GOV'T ACCOUNTABILITY OFFICE, HIGH-RISK SERIES: AN UPDATE (2009).

be adopted[66] because Volcker was also the chairman of the Group of Thirty Financial Reform Working Group, which issued a report in January 2009 advocating a two-tier regulatory structure. Under that proposal, one tier would provide more stringent regulation for large institutions and a second tier would have less regulation for smaller institutions.[67] That recommendation would have reversed the existing policy of deregulating larger institutions; that policy was based on what some now believe was a mistaken theory that large institutions had the sophistication to protect themselves and, therefore, did not need regulatory protection.[68]

Under Volcker's Group of Thirty proposal, institutions posing systemic risk would be restricted in their activities and prohibited from taking on certain risks, such as owning a hedge fund.[69] This appeared to be a return to the days of the Glass-Steagall Act of 1933,[70] which prohibited commercial banks from investment bank activities, until its repeal by the Gramm-Leach-Bliley Act in 1999 (GLB Act).[71] Critics of the GLB Act have charged that it was responsible for the subprime crisis. One of that legislation's sponsors, former Senator Phil Gramm, pointed out that it was commercial banks' traditional role as mortgage lenders that got them in trouble.[72] Citigroup, for example, had formed an amalgamation of financial services even before the GLB Act, though some of those services were prohibited by Glass-Steagall, *i.e.*, insurance underwriting.[73]

The ongoing subprime crisis dramatically illustrated the need for reform. Functional regulation had been unsuccessful, as demonstrated by impairment of the country's once-dominant financial services position. Certainly all of the existing layers of functional regulation did

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66. Volcker had served as chairman of a study by the Group of 30 on varying regulatory approaches around the world. That study group issued a report in October 2008 that seemed to favor the Twin Peaks approach. *See* GROUP OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE (2008).

67. GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009).

68. *See* Jerry W. Markham, *Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?* 12 YALE J. ON REG. 345 (1995) (discussing this regulatory approach).

69. GROUP OF THIRTY, *supra* note 67, at 8.

70. No one knows why Congress adopted the Glass-Steagall Act, other than that it was a panicked response to the ongoing economic crisis in the 1930s. That legislation only weakened banks, but we may now be repeating that mistake. *See generally* Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 236–37, 253–64 (2000).

71. *See* Paul J. Polking & Scott A Cammarn, *Overview of the Gramm-Leach-Bliley Act*, 4 N.C. BANKING INST. 1 (2000).

72. Phil Gramm, *Deregulation and the Financial Panic*, WALL ST. J., Feb. 20, 2009, at A17.

73. *See* CIT Group, Inc. v. Citicorp, 20 F. Supp. 2d 775 (D. N.J. 1998) (describing the breadth of financial services offered by Citicorp before the passage of the GLB Act).

nothing to inhibit the conduct or events that led to the subprime crisis. The Treasury Blueprint was, perhaps, the first reasoned approach to regulation since Alexander Hamilton's report to Congress in 1790.[74]

The existing regulatory structure has proved unable to effectively deal with systemic events associated with market bubbles and panics. Instead of a reasoned and rational approach to the effects of particular actions on the economy as a whole, the regulators acted independently, but predictably, to make a bad situation worse. The question at hand is whether such a rational approach will be set aside by the hysteria engendered by the subprime crisis, which has created a widespread desire to punish the business community for the failures that led to that crisis. Retribution may be satisfying but it will not correct a failed regulatory system.

IV. THE HISTORY OF THE SEC AND CFTC

A. Summary

The Treasury Blueprint is a studied effort to restructure the existing dysfunctional financial regulatory system into something more rational. One part of that effort is its recommendation to combine the SEC and CFTC. This recommendation seems, at least on the surface, to be an improvement because both agencies largely regulate financial products, and the two markets are rapidly converging. There are obstacles, however.[75] Perhaps the most formidable barrier will be the inevitable fight over allocation of jurisdiction for such a merged entity among competing congressional committees. Predictably, neither the congressional banking committees, in the case of the SEC, nor the agriculture committees, in the case of the CFTC, will be happy to give up their jurisdiction. Equally daunting are the challenges in combining the often-conflicting cultures of the agencies. The SEC and CFTC have a history of clashing over their respective jurisdictions, and their regulatory approaches are often sharply distinctive and incompatible.

The ongoing convergence of the securities and derivatives markets, nonetheless, makes such a combination attractive. However, the Treasury Department Blueprint recognizes that such a merger will be effective only if the new regulator can operate under a principles-based regulatory system. Such a system is employed by the CFTC and is better than the rules-based system of the SEC, which has proved to be a

74. *See* 1 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492–1900) 88–89 (2002).

75. *See infra* notes 300–75 and accompanying text.

costly failure. The SEC must radically change its culture to implement such a system. That will be no easy task.

B. Regulatory History

Regulation of financial services has a rocky history in the United States. The Bank of the United States created by Alexander Hamilton and chartered by Congress in 1791 was a joint private and governmental effort to regulate money markets in the United States after the Revolution.[76] Congress voted, however, to let the Bank's charter expire in 1816 after much opposition from private banks.[77] Congress chartered a second Bank of the United States in 1816, but it was destroyed in an epic political battle between President Andrew Jackson and Senator Henry Clay.[78] That ended governmental efforts to play a role in the private markets for decades.

Even the market depredations of the so-called robber barons after the Civil War in the markets escaped regulation. Jay Gould, Jim Fisk, and Daniel Drew were among the worst of those offenders, and their manipulation of railroad stocks and the gold market were legendary in their audacity.[79] But they drew no congressional response.[80] The seminal event that laid the groundwork for regulation of the securities markets was the panic of 1907, during which J.P. Morgan acted as a one-man central bank, marshalling the resources of the federal government and private banks to stop an unexpected and violent panic that threatened the entire financial system.[81] Ironically, Morgan's heroics went unrewarded and he soon became the subject of a witch hunt

76. RON CHERNOW, ALEXANDER HAMILTON 347–54 (2004). This model seems to have been followed for Freddie Mac and Fannie Mae. Chartering those privately owned entities to carry out governmental policy proved to be a failure during the subprime crisis; both failed and were placed in conservatorship by the government. They proved both to be a poor investment and even worse mechanism for carrying out government housing policy by encouraging loans to poor (subprime) borrowers. James R. Hagerty, *Paulson: Redo Fannie, Freddie*, WALL ST. J., Jan. 8, 2009, at A11.

77. RICHARD BROOKHISER, ALEXANDER HAMILTON, AMERICAN 215 (1999).

78. *See* JON MEACHAM, AMERICAN LION, ANDREW JACKSON IN THE WHITE HOUSE 208–10 (2008) (describing the political battle over the Bank of the United States).

79. *See generally* MAURY KLEIN, THE LIFE AND LEGEND OF JAY GOULD (1986) (describing Gould and his fellow operators).

80. Congress did regulate the railroads in 1887 through the Interstate Commerce Act of 1877, ch. 104, 24 Stat. 379 (codified as amended in scattered sections of 49 U.S.C.), that created the Interstate Commerce Commission. Congress also enacted the Sherman Antitrust Act, ch. 647, 26 Stat. 209 (1890) (current version at 15 U.S.C. §§ 1–7) in 1890 to meet rising concerns with the consolidation of several industries; Standard Oil raised the most alarm. *See generally* RON CHERNOW, TITAN, THE LIFE OF JOHN D. ROCKEFELLER, SR. (1998) (describing those concerns).

81. *See* ROBERT F. BRUNER & SEAN D. CARR, THE PANIC OF 1907, LESSONS LEARNED FROM THE MARKET'S PERFECT STORM (2007) (describing those events).

to determine whether U.S. finance was controlled by a "money trust."[82]

A congressional investigation led by Congressman Arsene Pujo of Louisiana, Chairman of the House Banking and Currency Committee (Pujo Committee), resulted in a headline-making revelation that interlocking boards of many major corporations gave the appearance of control over a large portion of the U.S. economy to a few individuals, such as J.P. Morgan, George F. Baker, an executive at the First National Bank in New York, and James Stillman, President of the National City Bank.[83] The Clayton Anti-Trust Act[84] was enacted and the Federal Trade Commission created in 1914 to address those concerns.[85] The most significant result of the congressional investigations that followed the 1907 panic was the creation of the Federal Reserve Board in 1913 despite strong efforts by President Woodrow Wilson to defeat the legislation.[86]

The Pujo Committee also investigated the New York Stock Exchange (NYSE) in its hunt for a money trust, and concluded that the NYSE's facilities were "employed largely for transactions producing moral and economic waste and corruption."[87] The Pujo Committee concluded that the NYSE was operating much like the futures exchanges, and that only a small fraction of trading on the NYSE was for investment. Most contracts were offset through "ring settlements" without taking delivery of the securities, much like futures contracts. Turnover in some stocks was extraordinary; for example, the Reading Railroad had its entire stock issuance sold forty times over in 1907.[88]

Low margins on the NYSE (10%) encouraged speculation.[89] The Pujo Committee was scandalized by its discovery that officers and directors of public companies were trading on inside information and that manipulation of stock prices was common through wash sales by "pools" of manipulators.[90] The Pujo Committee recommended that the NYSE be required to incorporate under state law, so New York could impose charter provisions requiring the exchange to restrict speculation

82. I have described those events in 2 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTOR (1900–1970) 31–53 (2002).

83. H.R. REP. No. 62-1593 (1913).

84. 15 U.S.C. §§ 1–7 (2006).

85. *See* 15 U.S.C. §§ 41–58.

86. *See* WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY 276–82 (1987) (describing those events).

87. H.R. REP. No. 62-1593, at 116.

88. MARKHAM, *supra* note 82, at 51.

89. *Id.*

90. *See* H.R. REP. No. 62-1593, at 47.

and abuses.[91] The Pujo Committee also concluded that there was a need for federal regulation, and it sought a requirement that corporations listed on the NYSE provide periodic accounting statements and a description of payments made to brokers, promoters, and others associated with issuing or underwriting company stock.[92]

Although no securities regulation resulted from the Pujo Committee investigation, it set a precedent for congressional oversight of the securities markets and educated Congress on the workings and abuses of the securities markets. When the stock market crash occurred in 1929, Congress pounced with hearings before its banking committees that revealed, once again, widespread abuses in trading NYSE stocks.[93] Congress consequently adopted the federal securities laws, including the Securities Exchange Act of 1934, which created the SEC.[94]

The selection of Joseph Kennedy as first SEC chair was surprising because he was a renowned stock market operator with a reputation for devious trading practices. But President Roosevelt thought the best approach was to "[s]et a thief to catch a thief."[95] Kennedy proved an effective administrator, but the agency was small and did nothing to restore confidence in the market. Capital was in hiding. The Roosevelt Administration's regulatory threats and massive tax increases resulted in a "serious strike of capital,"[96] and it was not until the outbreak of World War II in Europe that the U.S. economy began to recover.[97] The stock market did not regain its 1929 high until 1954,[98] at which point the SEC was considered a toothless, "moribund operation."[99]

C. Insider Trading Arrives

The SEC remained a small and somnolent agency until the 1960s, when a new activist chairman, William Carey, a Columbia University

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91. MARKHAM, *supra* note 82, at 52.

92. *See* H.R. REP. No. 62-1593, at 162–165.

93. *See* S. REP. No. 73-1455, (1934); H.R. REP. No. 37-85 (1933).

94. For a description of the background of the creation of the SEC and its development into a powerhouse agency see JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET (1982).

95. JOHN H. DAVIS, THE KENNEDYS, DYNASTY AND DISASTER 78 (1993).

96. AMITY SHLAES, THE FORGOTTEN MAN, A NEW HISTORY OF THE GREAT DEPRESSION 337 (2007).

97. The SEC was declared a nonessential agency during the war and was shipped off to Philadelphia to free up office space in Washington, D.C.

98. Chris Watling, *Britain is Headed for the Wilderness if We Borrow More Instead of Saving*, THE INDEPENDENT (London), Jan. 11, 2009, at 82.

99. ROBERT SOBEL, N.Y.S.E.: A HISTORY OF THE NEW YORK STOCK EXCHANGE (1935–1975) 183–85 (1975).

law professor, was appointed.[100] Carey strongly believed that large corporations needed to be strictly regulated.[101] His most aggressive act while chairman of the SEC was creating the crime of insider trading out of whole cloth.[102] The SEC acquired a reputation for thoroughness when it published its *Special Study of the Securities Markets* in 1963.[103] That study examined almost every aspect of the securities industry and found a number of flaws.[104]

The SEC gained new powers after the 1960s "paperwork crisis" exposed widespread problems in the operations of the securities industry. The industry nearly broke down during that crisis after several large NYSE firms failed because of their inability to handle increased trading volumes of 16 million shares per day.[105] The SEC used the paperwork crisis to gain additional authority from Congress in 1975.[106] That legislation allowed the SEC to regulate nearly all aspects of securities market practices, ranging from settlement and clearing[107] to net capital[108] to protecting customer funds.[109] The paperwork crisis created a moral hazard in the form of SIPC insurance for the customers

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100. *See* David Margolick, *William Carey, Former SEC Chairman, Dies at 72*, N.Y. TIMES, Feb. 9, 1983, at B12:

> "He was a pivotal figure who picked up the agency at a point where it had become a dreary, unaggressive overseer of Wall Street, and transformed it into an institution that worried about the really serious problems in the securities world," said Prof. Joel Seligman of Northeastern Law School, author of a recent history of the commission. "He was an absolute giant in the field."

Id.

101. Carey was particularly critical of the laxity of the Delaware corporate law in regulating corporations. *See, e.g.*, William Carey, *A Proposed Federal Corporate Minimum Standards Act*, 29 BUS. LAW. 1101 (1974); William Carey, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974).

102. *See In re* Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. Docket 907 (1961) and discussion *infra* notes 306–10 and accompanying text.

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

104. The SEC also conducted a study in 1971 on the growth of institutional trading, which was supplanting the individual investor. *See* INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. No. 92-64 (1971).

105. See STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, H.R. DOC. No. 92-231 (1971) (describing those failures and problems). Today, trading volumes of over one billion shares per day are common on both the New York Stock Exchange and the NASDAQ. On October 10, 2008, the NYSE handled volume of over 7 billion shares. *See* N.Y.S.E. Euronext, Firsts & Records, http://www.nyse.com/about/history/1022221392987.html (last visited Feb. 19, 2010).

106. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15, 16 U.S.C.).

107. 15 U.S.C. § 78q-1 (2006).

108. 17 C.F.R. § 240.15c3-1 (2009).

109. 17 C.F.R. § 240.15c3-3 (2009).

of failed broker-dealers.[110] The SEC also used the 1975 legislation to secure authority to implement a "central market" system (now called the "national market system"), though it became a continuing bone of contention over the years before culminating in Regulation NMS (National Market System).[111]

The 1970s witnessed another event that became legendary at the SEC: "Mayday," the day the SEC prohibited broker-dealers from fixing commissions—an industry practice instituted in 1792.[112] Several aggressive enforcement actions also raised the SEC's profile considerably in the 1980s.[113] The agency uncovered a vast system of payments from public companies based in the United States to foreign government officials to obtain business; this led to the Foreign Corrupt Practices Act of 1977.[114] The SEC became stridently independent during this process and was generally viewed to be a firm regulator; it even earned the laudatory title of "Eagle on the Street" by two Pulitzer-Prize-winning reporters at the *Washington Post* after the Ivan Boesky era scandals.[115]

D. SEC Regulatory Approach

The SEC is rules-oriented. It tries to dictate industry practice and control the flow of information into the securities markets through rules[116] or enforcement actions that substitute for rulemaking.[117] The

110. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636.(codified as amended at 15 U.S.C. §§ 78aaa–78lll, 78o (2006)).

111. Regulation NMS, 70 Fed. Reg. 37,496 (June 29, 2005). For a discussion of the development of the SEC's national market system see Junius W. Peake, *Entropy and the National Market System*, 1 BROOK. J. CORP. FIN. & COM. L. 301 (2007).

112. *See* Stanislav Dolgopolov, *Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, 4 J. L. ECON. & POL'Y 311 (2008) (describing this history).

113. For example, the National Student Marketing case set off a furor when the SEC staff launched an attack on its very prominent outside lawyers. *See* Sec. & Exch. Comm'n v. Nat'l Student Mktg Corp., 457 F. Supp. 682 (D.D.C. 1978). Robert Vesco's looting of the IOS mutual funds was another noteworthy event during this period. *See* ARTHUR HERZOG, VESCO (1987) (describing Vesco's escapades).

114. Pub. L. No. 95-213, 91 Stat. 1494 (codified as amended in scattered sections of 15 U.S.C.). The disclosure of Lockheed's payments to foreign government officials toppled governments around the world. *See* Daniel Patrick Ashe, *The Lengthening Anti-Bribery Lasso of the United States: The Recent Extraterritorial Application of the U.S. Foreign Corrupt Practices Act*, 73 FORDHAM L. REV. 2897 (2005) (describing the statute).

115. *See* DAVID A. VISE & STEVE COLL, EAGLE ON THE STREET (1991).

116. One example of that effort is Regulation FD that seeks to make information flows to financial analysts symmetric by prohibiting selective disclosures. 17 C.F.R. § 243.100 (2009);. *see* Yasuhiro Ohta and Kenton K. Yee, *The Fairness Opinion Puzzle: Board Incentives, Information Asymmetry, and Bidding Strategy*, 37 J. Legal Stud. 229, 258 n.20 (2008) ("Even though the goal of

SEC is also very protective of its jurisdiction and usually rejects regulatory efforts that do not originate with it. A good example of this rigidity was the SEC's refusal to accept international financial accounting requirements (IFRS) that were principles-based and used by most of the rest of world. Despite the IFRS's international popularity, the SEC clung tenaciously to the homegrown rulebook based on generally accepted accounting principles (GAAP).[118] The SEC required foreign issuers to reconcile their IFRS accounting statements with GAAP for filings with the agency.

After much criticism, the SEC dropped the requirement for foreign issuers to reconcile their financial statements with GAAP[119] and began to move toward embracing IFRS for U.S. issuers.[120] That seemed appropriate because GAAPs were manipulated on such a massive scale during the Enron-era scandals.[121] But even the SEC's flexibility regarding GAAPs seems to have gone by the wayside because of the subprime crisis. The new SEC chair stated that those international standards should be adopted cautiously, which may be a signal for retaining the complex GAAP rule formulations.[122]

E. Enron Unravels All

The SEC's reputation as a strong regulator unraveled during the Enron and WorldCom scandals. These scandals raised questions about the SEC's regulatory capabilities. Indeed, the entire accounting system appeared broken, with numerous restatements and accounting manipulations across a broad spectrum of firms. New York attorney

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Regulation FD was to improve dissemination of public information, many academics argue that Regulation FD has had a chilling affect on voluntary communication between firms and individual analysts.").

117. *See* ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VERSUS CORPORATE AMERICA (1982) (criticizing the creation of rules by prosecution).

118. *See* Maureen Peyton King, *The SEC's (Changing?) Stance on IAS*, 27 BROOK. J. INT'L L. 315 (2001) (describing this controversy and SEC reconciliation requirements between GAAP and international standards). *See generally* Lawrence A. Cunningham, *The SEC's Global Accounting Vision: A Realistic Appraisal of a Quixotic Quest*, 87 N.C. L. REV. 1, 3 (2008) (questioning SEC's change in approach for the acceptance of international standards, calling it "the most revolutionary securities law development since the New Deal").

119. Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. GAAP, Exchange Act Release No. 33-8879, 92 SEC Docket 717 (Dec. 21, 2007).

120. *U.S. Regulators Face Fight on IFRS Accounting Cost*, REUTERS, Nov. 18, 2008, http://www.reuters.com/article/politicsNews/idUSTRE4AI12K20081119.

121. I have described those manipulations in MARKHAM, *supra* note 58.

122. *Schapiro Vows to 'Reinvigorate' Enforcement at SEC if Confirmed*, 41 Sec. Reg. & L. Rep. (BNA) 77 (Jan. 19, 2009).

general Eliot Spitzer also made the SEC look weak and out-of-touch by exposing sordid practices by financial analysts who were privately disparaging stocks that they were publicly touting. Those analysts were at the heart of the SEC's full disclosure system, but the SEC failed in its purported watchdog role. This led to a phenomenal $1.4 billion settlement with the firms in the financial analysts scandal, which included Merrill Lynch and Citigroup.[123]

The settlement imposed pervasive and punitive regulation on financial analysts, and went so far as to require that an attorney be present to chaperone any meetings between financial analysts and investment bankers. That settlement resulted in less coverage of stocks by analysts, not better analysis. That diminished coverage accelerated during the subprime crisis. Between September 2008 and May 2009, financial analysts dropped coverage on more than 2,200 securities, which was about a quarter of all coverage of public companies in the United States.[124]

The SEC was sent reeling again after Spitzer exposed widespread market timing and late trading abuses in mutual funds by several hedge funds.[125] SEC Chair Harvey L. Pitt was driven from office by Spitzer's attacks on the SEC for lax regulation, and he was replaced by William Donaldson.[126] To restore the SEC's sullied reputation, Donaldson conducted a politicized campaign to jam through new regulations on mutual funds—an effort the District of Columbia Court of Appeals rejected.[127] The SEC then insolently and summarily readopted the rules without even awaiting the mandate of that court. The D.C. Circuit responded by once again striking the rules.[128] The D.C. Circuit also rejected the SEC's effort to require hedge funds to register as investment advisers.[129] Further humiliating the agency, the D.C. Circuit struck down the SEC's rules exempting fee-based brokerage accounts from the Investment Advisers Act of 1940.[130]

123. I have described those events in MARKHAM, *supra* note 58.

124. Jeff D. Opdyke & Annelena Lobb, *MIA Analysts Give Companies Worries*, WALL ST. J., May 26, 2009, at C1.

125. I have described that debacle in Jerry W. Markham, *Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 HASTINGS BUS. L.J. 67, 97–99 (2006).

126. Stephan Labaton, *Easy Sailing For Nominee To the S.E.C.*, N.Y. TIMES, July 27, 2005, at C1.

127. Chamber of Commerce of the U.S. v. Sec. & Exch. Comm'n, 412 F.3d 133 (D.C. Cir. 2005).

128. *Id.* I have described this episode in Markham, *supra* note 125, at 97–99.

129. Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873 (D.C. Cir. 2006). I have described this episode in Markham, *supra* note 125, at 104–05.

130. Fin, Planning Assoc. v. Sec. & Exch. Comm'n, 482 F.3d 481 (D.C. Cir. 2007). I have described this episode in MARKHAM & HAZEN, *supra* note 38, at § 3:8.50. That decision, unfortunately, affected the accounts of some 1 million customers holding $300 billion in funds. *See* Temporary Rule

F. The Subprime Crisis

The SEC seemed to be righting itself after the appointment of a new chairman, Christopher Cox, a former California congressman and securities lawyer. Though he initially appeared to have placed the agency on level footing, the subprime crisis sent it reeling once again. Cox's performance during the Bear Stearns crisis was particularly troubling.[131] For example, he assured the public that Bear Stearns had plenty of liquidity and was financially sound only three days before it failed as a result of a liquidity crisis.[132] The SEC's own Inspector General, thereafter, charged that the SEC had failed properly to supervise Bear Stearns.[133] The Inspector General continued with a string of embarrassing revelations, including a finding that one SEC attorney had allowed his bar registration to lapse for a fourteen-year period and that a SEC supervisory attorney had never been admitted to any bar.[134] The SEC Inspector General also criticized the SEC's program for monitoring insider trading by its own employees, finding that two senior enforcement attorneys were actively trading stocks during office hours.[135]

G. Madoff

Then there was the Madoff scandal. Bernard L. Madoff was a well-known figure in the securities business. He had helped build, and was a former chairman of, NASDAQ and had served on the board of

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Regarding Principle Trades With Certain Advisory Clients, 72 Fed. Reg. 55,022 (Sept. 28, 2007).

131. Kara Scannell & Susanne Craig, *SEC Chief Under Fire as Fed Seeks Bigger Wall Street Role—Cox Draws Criticism for Low-Key Leadership During Bear Crisis*, WALL ST. J., June 23, 2008, at A1.

132. Stephan Labaton, *S.E.C. Image Suffers in a String of Setbacks*, N.Y.Times, Dec. 16, 20008, at B6.

133. *Id.* SEC rules required broker-dealers that were a part of a holding company structure to file with the SEC disaggregated information on the firm's risk exposures. 17 C.F.R. §§ 240.17h-1T & 17h-2T (2009). These rules were adopted in the wake of the Drexel Burnham Lambert failure that raised concerns when capital was taken out of the broker-dealer subsidiary of that firm. The reports under those rules were intended to be used by the SEC staff to assess the risks to broker-dealers from affiliated entities. Amendments to Regulations for the Government Securities Act of 1986, 59 Fed. Reg. 58,792 (Nov. 15, 1994) (proposed rule). The SEC Inspector General found that the program was not being properly updated or administered by the SEC during the subprime crisis. *See* OFFICE OF THE INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, SEC'S OVERSIGHT OF BEAR STEARNS AND RELATED ENTITIES: BROKER-DEALER RISK ASSESSMENT PROGRAM (2008), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-b.pdf.

134. OFFICE OF THE INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, SEMIANNUAL REPORT TO CONGRESS (APRIL 1, 2008–SEPTEMBER 30, 2008) 11, 50–51 (2008), *available at* http://www.sec-oig.gov/Reports/Semiannual/2008/seminov08.pdf.

135. Labaton, *supra* note 132.

governors of the National Association of Securities Dealers (NASD).[136] He was also viewed as an industry innovator and a pioneer in electronic trading in the 1970s when he turned the Cincinnati Stock Exchange into an electronic market that traded NYSE-listed stocks.[137] In December 2008, Madoff was arrested after he confessed that he had been running a giant Ponzi scheme involving what he said were investor losses totaling $50 billion. He was supposed to be managing funds for wealthy investors, charities, universities, and fund-of-fund hedge funds, but instead he committed the largest investment fraud in history—and it generated a media circus.[138]

The SEC once again proved its ineptness. The agency was forced to admit that it had ignored repeated warning signals that something was amiss at the Madoff firm. Indeed, the SEC had received credible

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136. Robert Frank et al., *Fund Fraud Hits Big Names; Madoff's Clients Included Mets Owner, GMAC Chairman, Country-Club Recruits*, WALL ST. J., Dec. 13, 2008, at A1.

137. See Diana B. Henriques, *Madoff Scheme Kept Rippling Outward, Crossing Borders*, N.Y. TIMES, Dec. 20, 2008, at A1. The Cincinnati Stock Exchange was later moved to Chicago and renamed as the National Stock Exchange. Tom Lauricella & Aaron Lucchetti, *Madoff Brother, at Arm's Length?*, WALL ST. J., Jan. 10, 2009, at B1.

138. *See* Peter Lattman & Aaron Lucchetti, *Losses in Madoff Case Spread; Alleged Ponzi Scheme's Victims Include Lautenberg, Zuckerman, Spielberg's Charity*,. WALL ST. J., Dec. 15, 2008, at A1; Jenny Strasburg, *'Dr. Doom' Didn't Predict Madoff Blowup*, WALL ST. J., Dec. 31, 2008, at C1.

Other losses of $3.5 billion were sustained at Kingate Management $3.5; Tremont Group Holdings, a hedge fund owned by Massachusetts Mutual Life Insurance Co. lost $3.3 billion; Banco Santander lost $3.1 billion; HSBC Holdings, $1 billion; the Man Group, $360 million; the Royal Bank of Scotland, $360 million; Nomura Holdings, $302 million. The government of Austria was forced to take over Bank Medici, which lost more than $2 billion on a client funds through investments with Madoff. Nelson D. Schwartz, *European Banks Tally Losses Linked to Fraud*, N.Y. TIMES, Dec. 17, 2008, at B1. One unlucky investor, Martin Rosenman, gave Madoff $10 million only six days before he was arrested. Worse yet, Madoff collected $250 million from his good friend Carl Shapiro just 10 days before being arrested. Shapiro had already invested $150 million before that payment. Kenneth Langone, of Richard Grasso fame, declined a request from Madoff to make an investment. Robert Frank & Amir Efrati, *Madoff Tried to Stave Off Firm's Crash Before Arrest*, WALL ST. J., Jan. 7, 2009, at C1.

Thierry Magon de la Villehuchet, the cofounder of the investment advisory firm Access International Advisors that suffered $1.5 billion in losses from Madoff's fraud committed suicide on December 23, 2008. He personally lost $50 million of his own money in the Madoff fraud, as well as other family money. Alex Berenson & Matthew Saltmarsh, *The Suicide of a Trader Contributes to Mysteries*, N.Y. TIMES, Jan. 2, 2009, at B1. The Madoff scandal exposed another aspect of hedge fund investments, the money finders. These are individuals with family, social, or other connections with wealthy investors. The money finders are paid a fee, usually a percentage of the money they refer to the hedge fund, for this referral service. They are supposed to do their due diligence before making such recommendations, but their relationship with the hedge fund manager is often either social or fee-based, both of which discourage too much inquiry, which appears to be the case in the Madoff scandal. In addition some of the fund-of-funds were supposed to be receiving fees for finding and vetting the very best hedge fund managers, though they had done little due diligence. Some money managers claiming expertise were simply placing money with Madoff and claiming success from his supposed returns. *See generally* Holman W. Jenkins, Jr., *Mad Men*, WALL ST. J., Jan. 7, 2009, at A11 (discussing this problem).

allegations about the scheme at least nine years before Madoff's confession.[139] SEC Chair Christopher Cox publicly expressed his dismay over how the Madoff investigations were handled, and he asked the SEC Inspector General to review the SEC's response to those complaints and inquiries. Cox found the fact that the agency ignored the warning signals "deeply troubling" because the SEC had "specific and credible evidence" of the Ponzi scheme long before Madoff's confession.[140]

The SEC's effectiveness was called into question on other grounds. The SEC had previously claimed that it was necessary to require hedge funds to register as investment advisers under the Investment Advisers Act of 1940[141] in order to prevent fraud.[142] But the biggest fraud was operating with impunity under the SEC's nose, by one of its own registrants. Bernard Madoff had become a registered investment adviser in 2006, apparently as a result of the SEC's aborted efforts to require hedge funds to register. Unlike many hedge funds, however, Madoff did not drop his registration after the D.C. Court of Appeals struck the hedge fund registration requirement. Consequently, the SEC had all the regulatory authority it claimed to need with respect to a hedge fund like

139. The SEC had investigated Madoff's accountant Frank Avellino eighteen years before the discovery of the massive fraud. Avellino had been acting as a placement agent (money finder) for Madoff and was charged by the SEC with promising investors guaranteed returns of 20% per year. The SEC investigators thought that they had discovered a Ponzi scheme, but were reassured when Avellino explained that the funds were invested with Madoff. The SEC required Avellino to return $440 million of investor funds, but did not investigate to determine whether Madoff was actually running a Ponzi scheme. The SEC was also alerted in 2006 that Madoff had misled it on the nature of his investments. Alex Berenson, *'92 Ponzi Case Missed Signals About Madoff*, N.Y. TIMES, Jan. 17, 2009, at A1.

A 2001 article in *Barron's* magazine also questioned how Madoff could legitimately produce the large returns he was reporting. *See* Aaron Lucchetti & Tom Lauricella, *Sons' Role in Spotlight*, WALL ST. J., Jan. 24, 2009, at B1. In addition, Harry Markopolos, a rival investor, had been telling the SEC for years that the Madoff fund had to be a Ponzi scheme because the returns being reported by Madoff were completely unrealistic under the strategies he claimed to be using. Michael Lewis & David Einhorn, *The End of the Financial World as We Know It*, N.Y. TIMES, Jan. 4, 2009, at WK9. In total, Madoff's broker-dealer was examined eight times in sixteen years by the SEC and NASD (now FINRA), but they found no evidence of his Ponzi scheme and let him off the hook on a number of technical violations that they did discover. Berenson, *supra*.

140. Stephen Labaton, *S.E.C. Knew Him as Foe and Friend*, N.Y. TIMES, Dec. 18, 2009, at B1.

141. 15 U.S.C. §§ 80b-1–80b-21 (2006).

142. *See* Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,056 (Dec. 10, 2004). For a description of those scandals see Markham, *supra* note 125, at 79–98. In seeking to regulate the hedge funds, the SEC failed to recognize that the mutual funds played an equal role with the hedge funds in that scandal. Those mutual funds were subject to the Investment Company Act of 1940, 15 U.S.C. § 80a-1–80a-64 (2006), and were probably the most intensively regulated financial institutions in the country, but all of that regulation served no purpose. So why regulate the hedge funds? The SEC also faced a setback in the D.C. Circuit when it tried to impose a super-majority independent director requirement on mutual funds in response to the late trading scandal. *See supra* notes 125–28, and accompanying text.

Madoff's, but it failed to uncover his fraud despite substantive warnings that something was amiss. Even after that failure, the SEC sought once again to have hedge funds register as investment advisers.[143]

Madoff's brokerage firm was dually registered as a broker-dealer and as an investment adviser, yet the SEC failed to detect anything amiss.[144] SEC Chair Arthur Levitt even appointed Madoff to serve on an agency advisory committee.[145] More embarrassment followed with the discovery of several other Ponzi schemes.[146] In February 2009, another

143. Damian Paletta & Jenny Strasburg, *Treasury Maps New Era of Regulation*, WALL ST. J., Mar. 27, 2009, at A1.

144. Madoff was registered individually with the SEC as an investment adviser. He was also the sole owner of a company called Bernard L. Madoff Investment Securities, LLC (BMIS) that was dually registered with the SEC as a both a broker-dealer and an investment advisor. The SEC complaint against Madoff thus charges:

> BMIS is a broker-dealer and investment advisor registered in both capacities with the Commission. BMIS engages in three different operations, which include investment adviser services, market making services and proprietary trading. BMIS' website states that it has been providing quality executions for broker-dealers, banks and financial institutions since its inception in 1960;" and that BMIS,"[w]ith more than $700 million in firm capital, Madoff currently ranks among the top 1% of US Securities firms." The most recent Form ADV for BMIS filed in January 2008 with the Commission stated that BMIS had over $17 billion in assets under management, and 23 clients. BMIS represented that its trading strategy for adviser accounts involved trading in baskets of equity securities and options thereon.

Complaint at 4, Sec. & Exch. Comm'n v. Madoff, No. 08 CIV 10791 (S.D.N.Y. 2009), 2008 WL 51970702008 WL 5197070.

The SEC complaint further charged that Madoff conducted "certain investment advisory business for clients that is separate from the BMIS' proprietary trading and market making activities." *Id.* at 5. Madoff conducted his "investment adviser business from a separate floor in the New York offices of BMIS" and "kept the financial statements for the firm under lock and key, and was 'cryptic' about the firm's investment advisory business when discussing the business with other employees of BMIS." *Id.*

145. *See* Deborah Solomon, *Money Manager*, N.Y. TIMES MAGAZINE, Jan. 25, 2009, at MM11.

146. The Madoff scandal was followed a few weeks later with the discovery of a Ponzi scheme being run by Joseph Forte in Broomall, Pennsylvania. He took in $50 million before confessing his scheme to a postal inspector. Sarah N. Lynch, *New Ponzi Case Pursued*, WALL ST. J., Jan. 9, 2009, at C5.

Just when you thought you had seen everything, Marcus Schrenker, an investment advisor in Indiana accused of defrauding customers, jumped out of his airplane over Alabama. The crashed plane was discovered in Florida, two hundred miles away. No one was fooled, and Schrenker was found hiding in a campground near Quincy, Florida, where he slit one of his wrists just before being captured. Schrenker survived that suicide attempt. *Jailed Adviser is Criticized by Investors*, WALL ST. J., Jan. 23, 2009, at A11. In still another Ponzi scheme, Idaho authorities charged Daren Palmer and his hedge fund Trigon Group, Inc. with defrauding investors of over $100 million. That fraud was carried out over a period of over seven years. In Sarasota, Florida, Arthur Nadel, age 76, disappeared in January 2009, but was arrested later that month. He had been running hedge funds with nearly $350 million in assets, and which he reported were earning large returns between 2000 and 2006. John Kell, *Crisis on Wall Street: Fund Chief is charged With Fraud*, WALL ST. J., Jan. 22, 2009, at C3. Authorities took Nicholas Cosmo into custody on January 26, 2009 and charged him with operating a $380 million Ponzi scheme in Hauppauge, New York. He was selling investors private bridge loans for a minimum $20,000 massive fraud was revealed after the SEC charged R. Allen Stanford with defrauding investors of $8 billion.[147]

H. The CFTC's History

Though the commodity exchanges were largely untouched by federal regulation until the 1920s, they were not without their problems.[148] The Chicago Board of Trade (CBOT) was infamous, almost from its introduction of futures trading before the Civil War, for "corners" and other manipulative activities that adversely affected farm prices.[149] Although members of Congress introduced some 200 bills between 1880 and 1920 calling for regulation of the futures exchanges, none passed.[150] Nevertheless, regulation of the commodity futures markets preceded that of the securities markets. Some limited commodity market legislation was enacted before United States' entry into World War I, while stock market regulation would not arrive until the 1930s.[151]

Speculation associated with World War I led the FTC to conduct a massive study of the grain trade. Composed of seven volumes, the study isolated manipulative activities such as "corners" and "squeezes," which

investment and was promising returns of 48–80% percent per year. Leslie Wayne, *The Mini-Madoffs*, N.Y. TIMES, Jan. 28, 2009, at B1.

These cases confirm that the SEC had no ability to prevent or detect fraud until even the most fraudulent scheme was complete. Indeed, Ponzi schemes have been a perennial problem in the hedge fund arena. They have included David Mobley's Maricopa Index Hedge Fund in Naples, Florida, which defrauded investors of up to $350 million; the KL Group, which defrauded investors in Palm Beach of an estimated $200 million; and Bayou Securities, LLC, which defrauded investors of $450 million. Markham, *supra* note 125, at 120–21.

147. Harry Maurer & Cristina Linblad, *A New Massive Fraud*, Business Week, Mar. 2, 2009, at 5. The Stanford scandal was followed by the arrest of hedge fund managers Paul Greenwood and Stephen Walsh on charges of defrauding investors of $553 million. Victims included the University of Pittsburgh, which lost $65 million, and the Carnegie Mellon University, which lost nearly $50 million. Steve Stecklow et al., *Pair Lived Large on Fraud, U.S. Says*, WALL ST. J., Feb. 26, 2009, at A1.

148. Congress tried to prohibit gold futures trading during the Civil War, but gold prices then soared and the statute was repealed two weeks after its passage. MARKHAM, *supra* note 74, at 271.

149. Jerry W. Markham, *Manipulation of Commodity Futures Prices—The Unprosecutable Crime*, 8 YALE J. ON REG. 281, 288–98 (1991).

150. *See* JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 10 (1986).

151. The Cotton Futures Act was passed in 1914 and established a system for grading cotton and prohibiting all cotton futures contracts other than those specified in the statute. Ch. 255, 38 Stat. 693 (1914). That statute was declared unconstitutional because it was passed under Congress's taxing power but did not originate in the House. Hubbard v. Lowe, 226 F. 135 (S.D.N.Y. 1915). It was replaced by the Cotton Futures Act, ch. 313, pt. A, 39 Stat. 446, 476 (1916). The Grain Standards Act, ch. 313, pt. B, 39 Stat. 446, 482 (1916), authorized the Secretary of Agriculture to determine grade and inspection procedures for grain. The Warehouse Act, ch. 313, pt. C, 39 Stat. 446, 486 (1916), authorized the Secretary of Agriculture to license and inspect warehouse operators that stored agricultural products, but this was a voluntary program.

disrupted markets and pricing.[152] This study led to the Future Trading Act,[153] but the Supreme Court held the Act unconstitutional because it improperly relied on Congress's taxing power.[154] This brief setback was overcome when a market manipulation on the day after the Supreme Court's decision led Congress to pass the act again, this time under its Commerce Clause powers.[155] The second statute was renamed the Grain Futures Act (GFA)[156] and was upheld by the Supreme Court.[157]

The GFA limited futures trading to "contract markets" licensed by the federal government, thereby sanctioning an exchange monopoly and establishing the exclusivity of those exchanges over trading in futures contracts.[158] The theory was that limiting trading to "contract markets" would promote the dissemination of price information, expand regulation and monitoring of the marketplace, and eliminate bucket shops; this would be most easily accomplished by granting "contract market" status exclusively to exchanges that would police themselves to protect their licenses.

The legislation also established what would later become the Commodity Exchange Commission, composed of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General, which was authorized to suspend or to revoke the registration of the contract market if it failed to prevent manipulative activity by its members.[159] Day-to-day administration of the statute was placed in the hands of the Grain Futures Administration, a small bureau located in the Department of Agriculture, which proved to be ineffective.[160]

Like the stock markets, the grain exchanges were named as one of the culprits leading to the Great Depression. In the case of the commodity markets, depressed grain prices were blamed on speculators operating on those exchanges.[161] After finishing with the stock markets, Congress, then turned it focus to the futures markets and passed the Commodity

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152. *See* 1–7 FED. TRADE COMM'N, REPORT OF THE FEDERAL TRADE COMMISSION ON THE GRAIN TRADE (1921).

153. Ch. 86, 42 Stat. 187 (1921).

154. Hill v. Wallace, 259 U.S. 44 (1922).

155. *See* H.R. REP. No. 67-1095, 2 (1922).

156. Ch. 369, 42 Stat. 998 (1922).

157. Bd. of Trade v. Olsen, 262 U.S. 1 (1923).

158. The GFA authorized the Secretary of Agriculture to designate a "board of trade" as a "contract market." Once registered, the contract market was required to police its members' conduct to prevent manipulation and dissemination of false reports that could affect commodity prices. § 4, 42 Stat. 998 at 1000.

159. *Id.* § 6.

160. Markham, *supra* note 149, at 302–06.

161. MARKHAM, *supra* note 150, at 23–26.

Exchange Act (CEA).[162] Though the CEA prohibited commodity price "manipulation," its failure to define the term would cause uncertainty and result in time-consuming and expensive litigation that the government often lost.[163]

The CEA had a number of other flaws. For example, the CEA was limited to the trading of options and futures contracts on certain enumerated commodities.[164] As futures trading expanded to other commodities, the CEA was amended to bring those futures contracts within its reach. The amendments always lagged behind the development of new contracts, which allowed the speculators trading the unregulated contracts to avoid regulation for a time.

The CEA renewed the Commodity Exchange Commission. The Department of Agriculture again carried out the day-to-day administration of the CEA, this time through a renamed bureau call the Commodity Exchange Authority. The Commodity Exchange Authority was a little-known agency in the Department of Agriculture until an explosion in commodity prices in the 1970s.[165] That inflation was blamed on futures speculators, which aroused the ire of consumers and Congress—a situation strongly reminiscent of the commodity price run-up in 2008.[166] Scandals in the trading of commodity options, and concerns over price manipulations involving sales of grain to the Soviet Union, added to the concern and made legislation inevitable.

The commodity markets fought off legislation in 1968 that would have given the Commodity Exchange Authority teeth. Minor amendments were made in 1968, but none measurably strengthened the Commodity Exchange Authority. But the turmoil in the market in the 1970s gave Congress sufficient leverage to pass broad and intrusive regulation over the commodity exchanges.[167] That legislation, the

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162. Ch. 545, 49 Stat. 1491 (1936).

163. *See generally* Markham, *supra* note 149. The CEA sought to curb speculation by creating position limits that restricted the amount of futures contracts that could be held by any one speculator. The statute continued to regulate the contract markets by requiring their registration and imposing duties on those exchanges to prevent manipulation. "Futures commission merchants," which are brokerage firms that accept orders and funds from customers on the contract markets, were also required to register. § 10, 49 Stat. at 1500

164. *See* §§ 4–4i, 49 Stat. at.1492–97.

165. The "Great Salad Oil Swindle" occurred on the Commodity Exchange Authority's watch in 1962. That scandal involved Anthony DeAngelis, the "salad oil king," who was issuing fraudulent warehouse receipts on soybean oil held in warehouse tanks that did not exist. He was also speculating heavily in soybean futures contracts. Discovery of that fraud set off a market panic. *See* NORMAN C. MILLER, THE GREAT SALAD OIL SWINDLE (1965).

166. MARKHAM, *supra* note 150, at 56–65.

167. *Id.* at 52–56. Among other problems, a scandal, called the "great grain robbery," arose over the large profits being made by grain companies from sales of grain to the Soviet Union. "The 'grain robbery' of 1972 was one of those economic events that, like the OPEC oil embargo . . . can truly be

Commodity Futures Trading Commission Act of 1974 (CFTC Act), created a new federal regulatory agency, the Commodity Futures Trading Commission (CFTC), which was to be the futures industry analogue to the SEC.[168] The CFTC Act expanded the scope of the CEA to include all commodities without enumeration, which swept up even futures contracts on financial instruments. The CFTC was given broad powers, including injunctive authority to stop violations and to impose civil penalties of up to $100,000 per violation. Additional categories of new registrants were added, including commodity pool operators and commodity trading advisors.[169]

I. CFTC Challenges

The CFTC faced challenges from the moment it was created. It was a small agency that did not have the resources to police the commodity markets effectively. This became clear in connection with over-the-counter commodity options firms.[170] The legislation creating the CFTC preempted the SEC's authority to regulate those firms. The SEC exercised that authority to stop mass fraud of such instruments in the early 1970s.[171] Preemption by the CFTC, however, led to another round of fraud by renegade commodity option firms, which the CFTC was powerless to stop. In desperation, the CFTC imposed a temporary ban

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said to have changed the world." DAN MORGAN, MERCHANTS OF GRAIN 120–21 (4th ed. 1979).

168. Pub. L. No. 93-463, 88 Stat. 1389. Apparently the White House asked SEC Chairman Ray Garrett whether the SEC would like to take control of the futures markets before this legislation was introduced. He declined, so the CFTC was created instead. John D. Benson, *Ending the Turf Wars: Support For a CFTC/SEC Consolidation*, 36 VILL. L. REV. 1175, 1175 (1991).

169. § 202, 88 Stat. at 1395–96.

170. *See* Jerry W. Markham & David J. Gilberg, *Stock and Commodity Options—Two Regulatory Approaches and Their Conflicts*, 47 ALB. L. REV. 741, 762–68 (1983) (describing the CFTC's problems regulating commodity options).

171. The SEC viewed the Commodity Exchange Authority as a toothless tiger after that agency failed to do anything to stop widespread fraud in commodity options in the 1970s. The Commodity Exchange Authority stood aside as the SEC took a very expansive view of its own jurisdiction over such options. The SEC sued those firms claiming that the options they were selling to the public were securities, thereby pulling those instruments under SEC jurisdiction. The courts never definitively determined whether the SEC actually had the power to regulate those firms, but the SEC and state securities regulators continued to claim such authority. *Id.*

That jurisdictional claim over commodity options allowed the SEC to pull the Chicago Board Options Exchange, Inc. (CBOE) within its regulatory ambit when that exchange was created in 1973. The CBOE was created by the CBOT to apply futures trading principles to securities. To get the exchange off the ground, however, the CBOT was forced to submit to SEC jurisdiction. According to a subsequent decision by the Seventh Circuit Court of Appeals, however, if the CBOT had waited only one more year, the CBOE would have been regulated by the CFTC under the CFTC Act of 1974. Because the CBOE was already registered with the SEC as a national securities exchange, it was not within the reach of that statute. Bd. of Trade v. Chi. Bd. Options Exch., Inc., 677 F.2d 1137, 1140 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982).

on all commodity options. This led to much criticism of the CFTC and it further weakened the agency. The CFTC tried to limit commodity options trading, for the most part, to the regulated commodities exchanges,[172] but continued to be plagued by numerous fraudulent fly-by-night operations selling off-exchange options and other instruments, particularly in foreign currency. The CFTC's efforts to thwart that fraud were limited by its jurisdiction over foreign currency—which Congress reserved for the bank regulators when it passed the CFTC Act.[173] In 2000, the CFTC obtained corrective legislation, but a Seventh Circuit decision undercut those amendments,[174] and further legislation was necessary in 2008—not exactly a good track record on this issue.[175]

The CFTC faced other crises. First, in 1976, a giant manipulation and default of futures contracts on the potato market took place.[176] Then the oil-rich Hunt family of Dallas, Texas, made headlines when members collectively purchased a massive amount of soybean contracts on the CBOT.[177] Finally, the Hunt family again played a prominent role in the "silver crisis" in 1980, which threatened the viability of a large broker-dealer.[178] This was the first clear warning that the commodity futures markets and the securities markets were becoming intertwined and that a failure in one market could reverberate into the other.[179]

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172. *See supra* note 171 and accompanying text.

173. *See* Dunn v. CFTC, 519 U.S. 465, 472 (1997) (describing that limitation).

174. In that decision, the Court held that "spot" foreign currency transactions traded over-the-counter were not subject to CFTC regulation. The Seventh Circuit so ruled despite clarifying efforts of Congress under the Commodity Futures Modernization Act of 2000, which sought to assure that the CFTC had broad jurisdiction over foreign currency trading that involved retail customers. Commodity Futures Trading Comm'n v. Zelner, 373 F.3d 861 (7th Cir. 2004); *accord* Commodity Futures Trading Comm'n v. Erskine, 512 F.3d 309 (6th Cir. 2008).

175. The new amendments were included in the CFTC Reauthorization Act of 2008, which was enacted as Title XIII of the Food, Conservation, and Energy Act of 2008, Pub. L. No. 110-234, 122 Stat. 923. Under the 2008 legislation, the CFTC was given regulatory authority over all-exchange retail transactions in foreign currency that were offered on a leveraged or margin basis, or financed by the offeror or its affiliates. The legislation created a new category of registrants, "retail foreign exchange dealers." Such registrants are required to have minimum adjusted net capital of $20 million. This net capital requirement was applied to futures commission merchant's acting as foreign-currency counterparties. The CFTC was also given broader regulatory authority over the foreign currency market and its participants, including commodity pool operators and commodity trading advisors.

176. That affair is described in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Curran*, 456 U.S. 353, 369–71 (1982).

177. Commodity Futures Trading Comm'n v. Hunt, 591 F.2d 1211 (7th Cir. 1979).

178. *See* HARRY HURT III, TEXAS RICH: THE HUNT DYNASTY FROM THE EARLY OIL DAYS THROUGH THE SILVER CRASH 395–420 (1981) (describing the silver crisis).

179. The Hunts failed to meet margin calls on their silver futures contracts in March 1980 as several prices plunged. That failure nearly bankrupted one of their brokers, Bache & Co., which was a futures commission merchant, but was also one of the country's largest broker-dealers. Merrill Lynch was also facing massive losses as a result of the Hunts' failure to meet margin calls on their silver futures positions held at Merrill, which was also a registered futures commission merchant. The Hunts'

J. Financial Futures

Soon after the CFTC was created, the CBOT introduced a futures contract on Government National Mortgage Association (GNMA or Ginnie Mae) pass-through certificates that the CFTC approved without consulting the SEC. Those certificates involved pooling a bundle of mortgages into a trust or other special-purpose entity. Certificates of ownership were then sold in that pool. The certificate holders were paid monthly mortgage payments in aliquot portions from the pool. The value of these certificates fluctuated as interest rates changed. Although it was not required to register with the SEC under the Securities Act of 1933, the GNMA pass-through certificate was considered a securities industry product and was therefore regulated by the SEC. The SEC also viewed GNMA futures to be the equivalent of "when issued" GNMAs.[180]

Futures contracts on the GNMA securities were immediately successful and that success was followed by innovative futures contracts on stock indexes, such as the S&P 500, and later the Dow Jones indexes. The approval of those futures contracts, which the SEC continued to view as securities industry products, set off a long-running war between the SEC and CFTC over which agency should have jurisdiction over such instruments. That fight, however, did nothing to slow the CFTC's approval of more futures-style trading on financial instruments, including government securities.[181]

The SEC retaliated by asking Congress to remove jurisdiction from the CFTC over futures and options on securities products. In 1978, during the CFTC's congressional reauthorization hearings, the SEC sought jurisdiction over futures contracts where the underlying "commodity" was a security. The GAO supported the SEC's request.[182] The Treasury Department also sought a jurisdictional change to give it a regulatory role over futures contracts where the underlying commodity was a government security. Congress rejected both those requests but did require the CFTC to "maintain communications" with the SEC, the

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defaults were so serious that they were viewed as a systemic risk. Federal Reserve Board Chairman Paul Volcker was called out in the middle of the night in his pajamas to bless a $1.1 billion loan to bail out Bache, Merrill Lynch, and other brokerage firms. *See* Peter W. Bernstein, *Engelhard's Not-So-Sterling Deal with the Hunts*, FORTUNE MAGAZINE, May 19, 1980, at 84. The SEC conducted a massive study of that event to measure the danger presented by futures business to the broker-dealers it regulated, but not much was done to prevent future problems. U.S. SEC. & EXCH. COMM'N, THE SILVER CRISIS OF 1980: A REPORT OF THE STAFF OF THE U.S. SECURITIES AND EXCHANGE COMMISSION (1983).

180. *See* MARKHAM, *supra* note 150, at 81–83 (describing this event).

181. *See* Lily Tijoe, *Credit Derivatives: Regulatory Challenges in an Exploding Industry*, 26 ANN. REV. BANKING & FIN. L. 387 (2007) (describing these ongoing jurisdictional fights).

182. The GAO was later renamed as the Government Accountability Office.

Treasury Department, and the Federal Reserve Board. Congress further instructed the CFTC to consider the views of the Treasury Department and the Federal Reserve Board. The SEC, pointedly, was not on that last list. Clearly, the futures markets had powerful friends on the agriculture committees (which considered the legislation) who were not about to cede that jurisdiction to the banking committees.[183]

The SEC did not take defeat gracefully. It retaliated by approving the trading of GNMA options on the Chicago Board Options Exchange, Inc. (CBOE), which the SEC regulated, so that the securities industry could compete with the GNMA futures. That action was taken over the objections of the CBOT. But the SEC failed to consider that the futures business was a major industry in Chicago and that the Seventh Circuit Court of Appeals would protect it. Judges on that court included some antiregulatory adherents from the University of Chicago Law School's theory of law and economics, a school of thought disenchanted with the SEC. The Seventh Circuit held that the CFTC had exclusive jurisdiction over such instruments, so they could not be traded on the CBOE.[184]

That litigation brought the SEC to the negotiating table. In 1982, the CFTC and SEC settled some jurisdictional differences through the so-called Shad-Johnson Accords—an agreement between the chairmen of the two agencies—that was subsequently enacted.[185] That agreement confirmed the CFTC's authority to approve futures and options on futures contracts on broad-based indexes, and allowed index options to be traded on the CBOE and other option exchanges regulated by the SEC.[186] Jurisdiction over options trading on currency was split between

183. MARKHAM, *supra* note 150, at 99–100.

184. Bd. of Trade v. Chi. Bd. Options Exch., Inc., 677 F.2d 1137 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982).

185. Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294.

186. The legislation that enacted the Shad-Johnson Accords into law also divided jurisdiction between the SEC and CFTC over commodity pools, which is the futures industry analogue to the mutual fund, but became more widely used as a device for hedge fund asset management. The SEC was authorized by the 1982 amendments to treat the sale of interests in such pools as securities but could not regulate their operations. Rather, the CFTC was given exclusive jurisdiction over the operations of commodity pools. Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294. At the time, commodity pools were a very obscure investment vehicle for managed futures trading, but the rise of the hedge funds and their desire to trade highly leveraged instruments such as those regulated by the CFTC made the commodity pool an important investment medium in future years.

The 1982 amendments also required a joint study by the SEC, CFTC, the Federal Reserve Board, and the Department of the Treasury on the economic effects of options and futures trading, including any effects on capital raising. The study, when completed, concluded that financial futures and options did not have any measurable adverse affects on the formation of capital and even enhanced liquidity in some markets. The study also determined that the options contracts regulated by the SEC and those regulated by the CFTC differed in some respects; they also had common elements and both served similar economic functions. The two markets were found to be closely interrelated and close coordination of regulation was urged. The study concluded that the separate regulation by the SEC and the SEC and CFTC. The agreement also gave the SEC, in effect, veto power over new stock index futures contracts approved by the CFTC. If the SEC exercised that power, the CFTC could challenge it in court. A dispute soon broke out between the SEC and CFTC over that veto power, which required another interagency agreement (Joint Policy Statement).[187]

K. The Stock Market Crash of 1987

Futures contracts traded on securities resulted in a great deal of trading by institutions that had previously shunned the commodity markets. A number of new trading strategies were also developed. Those strategies included "dynamic hedging" and "portfolio insurance," which allowed portfolio managers to protect their portfolios from, or expose them to, market changes without liquidating the assets held in the portfolio. "Program trading" was another new popular addition to the market, involving trading on the basis of signals generated by computer programs that predicted market changes through mathematical models, which analyzed massive computerized databanks for trends that appeared to repeat over time.[188]

This raised the "Cascade Theory," a concern that coupling financial futures with computerized trading programs might pose a danger to the markets.[189] While each computerized trading program had individual variations and nuances, they generally shared a common feature: in the event of a market decline the computer programs would all generate sell signals. That selling would push the market down further, which would generate more sell signals, which would push prices down even further, and generate more sell signals. Critics were concerned that the computers would create a descending spiral—a cascade—that would continue until the market collapsed.[190]

That prophesy was nearly fulfilled in the Stock Market Crash of 1987, when the Dow Jones Industrial Average dropped more in absolute and relative terms than the sell off in the Stock Market Crash of 1929. The 1987 crash paralyzed the NYSE because it simply did not have the

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CFTC of functionally similar contracts had not caused any harm, although there had been some aberrations in arbitrage trading between the two respective markets. *See* MARKHAM, *supra* note 150, at 111–12.

187. Edward J. Kane, *Regulatory Structure in the Futures Markets: Jurisdictional Competition Between the SEC, the CFTC, and Other Agencies*, 4 J. FUTURES MKTS. 367, 375 (1984).

188. Jerry W. Markham & Rita McCloy Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L.J. 1993, 1999–2001 (1988).

189. *Id.* at 2014.

190. *Id.* at 2001.

capacity to handle the unexpected volume and price volatility. NASDAQ market makers also fled, leaving their customers stuck in the market as prices crashed. The commodity exchanges continued to function throughout the crisis.[191]

A number of studies were conducted after the Stock Market Crash of 1987 to determine whether the commodity futures markets should be further regulated. The SEC advocated adopting crippling margin requirements that would curb speculation in the futures markets. President Ronald Reagan created a presidential task force to consider that and other issues raised by the 1987 crash; the Task Force on Market Mechanisms (Brady Commission) was headed by Nicholas Brady, who later became Secretary of the Treasury. The Brady Commission concluded that the uncertain division of regulatory jurisdiction between the SEC and the CFTC over futures products on securities was a culprit in the crash.[192] Some critics sought a merger of the two agencies, and the SEC tried to claim the role of super regulator,[193] but the Brady Commission did not believe a merger would create an effective inter-market regulator. Instead, the Brady Commission recommended that the Federal Reserve Board be tasked with promulgating regulations that would cut across the securities and commodity markets.[194] That recommendation was not followed.[195]

Following the Stock Market Crash of 1987, President Ronald Reagan created an interagency task force responsible for coordination regulation between the stock and futures markets. This group, called the President's Working Group on Financial Markets (PWG), was

191. U.S. GOV'T ACCOUNTING OFFICE, FINANCIAL MARKETS: PRELIMINARY OBSERVATIONS ON THE OCTOBER 1987 CRASH 63 (1988).

192. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (1988) [hereinafter MARKET MECHANISMS].

193. Two of the five SEC commissioners dissented from the SEC's effort to make itself the super regulator. Markham & Stephanz, *supra* note 188, at 2027 n.223.

194. MARKET MECHANISMS, *supra* note 192, at 61–63.

195. There have been other calls for consolidated regulation. *See* Richard Carlucci, Note, *Harmonizing U.S. Securities and Futures Regulations*, 2 BROOK. J. CORP. FIN. & COM. L. 461 (2008); Elizabeth F. 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); Kai Kramer, *Aren't We Still in the "Garden of Forking Paths"? A Comment on Consolidation of the SEC and CFTC*, 4 HOUS. BUS. & TAX L. J. 410 (2004); Mark Frederick Hoffman, *Decreasing the Costs of Jurisdictional Gridlock: Merger of the Securities and Exchange Commission and the Commodity Futures Trading Commission*, 28 U. MICH. J.L. REFORM 681 (1995); Benson, *supra* note 168; Alan Schick, *A Review and Analysis of the Changing Financial Environment and the Need for Regulatory Realignment*, 44 BUS. LAW. 43 (1988). In 1990, Representatives Dan Glickman and Dennis Eckart, introduced a bill that would have merged the CFTC and SEC into a new Markets and Trading Commission. H.R. 4477, 101st Cong. (1990). A similar bill was introduced in 1995 by Representatives Wyden and Leach. H.R. 718, 104th Cong., 1st Sess. (1995).

composed of the heads of the Department of the Treasury, Federal Reserve Board, SEC and CFTC.[196] The Secretary of the Treasury led the group.[197] Future jurisdictional battles between the SEC and the CFTC would be fought through the PWG. After its formation, the PWG took up regulatory issues concerning over-the-counter derivatives, hedge funds, private equity, and various policy initiatives involving the financial markets.[198]

The Stock Market Crash of 1987 renewed conflict between the SEC and the CFTC. The SEC wanted the federal government, instead of the exchanges, to regulate stock index futures margins in order to raise their margins and to curb speculation.[199] As the Treasury Blueprint noted, however, margin plays distinct roles in the securities and futures industries. In the securities industry, margin is used as a credit control device to limit the funds that can be used for speculation or investment. In contrast, margin in the futures industry is used only to protect credit, i.e., it is used as a down payment to assure performance on the contract.[200]

Congress compromised by delegating the authority to set margin on stock-index contracts to the Federal Reserve Board, which delegated its authority to the CFTC, which delegated its authority to the exchanges—so nothing changed and the SEC and the CFTC continued to fight over margins.[201] For example, the Treasury Blueprint noted that the SEC and the CFTC agreed in principle on how to margin portfolios with diversified risks, but could not agree on the specifics of reaching that goal.[202] The issue of increasing margins to limit speculation was again raised during the subprime crisis when commodity prices spiked. But that spike was just that—a spike—and the concern over margin levels as a way to curb speculation eased when commodity prices declined.[203]

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196. Nathaniel C. Nash, *White House Group Recommends Only Limited Changes in Markets*, N.Y. TIMES, May 17, 1988, at A1.

197. U.S. Dep't of Treasury, Office of Financial Market Policy, http://www.treas.gov/offices/domestic-finance/financial-markets/fin-market-policy/ (last visited Feb. 20, 2010).

198. *See id.*

199. For a description of this debate see Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry—History and Theory*, 64 TEMP. L. REV. 59, 119-23 (1991).

200. TREASURY BLUEPRINT, *supra* note 8, at 116.

201. Jerry W. Markham, *The CFTC Net Capital Rule—Should a More Risk-Based Approach be Adopted?*, 71 CHI.-KENT L. REV. 1091, 1093 n.12 (1996).

202. TREASURY BLUEPRINT, *supra* note 8, at 116.

203. Gregory Meyer, *Margins Loom Large in Oil-Trading Probe*, WALL ST. J., June 25, 2008, at C13. There have been numerous efforts to use margin requirements to curb speculation and futures contracts over the years through increased margin requirements. The commodity exchanges have beaten back all of those efforts. One dramatic example involved the widespread speculation that occurred after

The conflict between the SEC and the CFTC continued after the Stock Market Crash of 1987. A fight broke out between the two agencies in 1989 over securities exchanges' use of "index participations." These instruments were cash-settled contracts on an index of securities that operated like futures contracts, but were traded on the securities exchanges. The Seventh Circuit intervened once again and held that the CFTC had exclusive jurisdiction over those instruments, which meant that they could not be traded on the securities exchanges. The Seventh Circuit further held that if an instrument had elements of both securities and futures, then the CFTC would have exclusive jurisdiction.[204]

That decision was a slap in the SEC's face, but it continued to battle with the CFTC. In an incredible act of chutzpah, the SEC allowed the securities exchanges to trade option contracts on some popular sub-indexes generated by Dow Jones. At the same time, the SEC exercised its veto authority and prohibited trading futures contracts on the same indexes. That discriminatory action resulted in another challenge in the Seventh Circuit, and the SEC lost again. The Seventh Circuit noted that the SEC's order implementing its veto disagreed with how the CFTC regulated the futures markets, stating, among other things, that margins were too low in the industry. The Seventh Circuit not too gently suggested that such concerns were not the SEC's business, but a matter for Congress.[205]

V. OTC DERIVATIVES

A. New Products

Financial engineering became a phenomenon in the last three decades of the twentieth century. In addition to financial futures, a wave of new

World War II in the commodity futures markets. President Truman then launched an assault in the press on the commodity exchanges that were refusing to boost their margins to levels the administration thought would stop that speculation. Markham, *supra* note 199, at 77–78. Those charges came back to haunt Truman. A select committee of Congress found that confidential government information had been used to profit from trading futures contracts on a number of agricultural commodities. Some 900 federal government employees were speculating in the commodity markets and made over $10 million in profits. One clerk in the Navy Department was trading millions of bushels of wheat, oats, corn, lard, cotton and eggs. The scandal turned ugly when it was discovered that Ed Pauley, President Truman's personal physician, and General Wallace Graham, one of Truman's cronies, were among the commodity speculators. Graham admitted to profits of $1 million. Those and other scandals tainted the Truman administration as corrupt. In the end, there was no proof that the speculators caused the price rises, but it made great theater. MARKHAM, *supra* note 82, at 272–73.

204. Chi. Mercantile Exch. v. Sec. & Exch. Comm'n, 883 F.2d 537 (7th Cir. 1989).

205. *See* Bd. of Trade v. Sec. & Exch. Comm'n, 187 F.3d 713 (7th Cir. 1999).

instruments appeared after the CFTC was created that contained elements of futures or options. The CFTC was faced with decisions on whether and how to regulate such instruments. If CFTC had jurisdiction over those instruments, the exchange-trading requirement would have precluded their use because over-the-counter dealers could not act as self-regulators or incur the expense of such regulation. In addition, institutional traders neither wanted nor needed the CEA's regulatory protection.[206]

A fight over futures-type trading in the Brent oil market resulted in a district court decision that such transactions were futures contracts subject to the CEA, even though the institutions trading in the market needed no such protection.[207] That decision threatened to shut down that market, at least in the United States, until Congress acted to allow the CFTC to exempt that market from contact market registration requirements.[208] Another new contract, the swap, was immediately popular in the financial markets. It too was not tradable on the exchanges and would have perished if an exchange-trading requirement had been imposed.[209] Other instruments with hybrid features included bonds that had a fixed interest rate of return with a commodity price kicker that would provide an additional return if a commodity, such as silver or oil, increased by a specified amount; the bond holder paid for the commodity price kicker by receiving a lower interest rate than would be paid on a comparable instrument without such a feature.[210]

The CFTC tried to regulate these and other instruments by ascertaining whether their options or futures elements outweighed their other features; this created much confusion and complexity.[211] In 1989, the CFTC issued a policy statement that exempted swap transactions from its regulatory reach,[212] but there was uncertainty over whether the CFTC had the power to do so. To provide more certainty, the Futures Trading Practices Act of 1992 authorized the CFTC to exempt swaps, which it did.[213] The CFTC also exempted various over-the-counter

206. For a description of these instruments and the CFTC's efforts to regulate them, see Jerry W. Markham, *Regulation of Hybrid Instruments Under the Commodity Exchange Act: A Call for Alternatives*, 1990 COLUM. BUS. L. REV. 1 (1990) and Jerry W. Markham, *"Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments*, 25 SETON HALL L. REV. 1 (1994).

207. Transnor (Bermuda) Ltd v. BP N. Am. Petroleum, 738 F. Supp. 1472 (S.D.N.Y.1990).

208. *See* Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590.

209. *See* Mark D. Young & William L. Stein, *Swap Transactions Under the Commodity Exchange Act: Is Congressional Action Needed?* 76 GEO. L. J. 1917 (1988).

210. *See* Markham, *supra* note 206.

211. Regulation of Hybrid Instruments, 54 Fed. Reg. 30,684 (July 21, 1989).

212. Policy Statement Concern Swap Transactions, 54 Fed. Reg. 30,694 (July 21, 1989).

213. *See* Futures Trading Practices Act of 1992 § 502, 106 Stat. at 3629.

energy contracts in the wake of the Brent oil market decision as well as other hybrid instruments.[214]

Use of derivatives dealer firms that arranged transactions and guaranteed their performance grew the swaps market rapidly. In the 1990s, the growth of OTC derivatives trading by many large financial institutions regulated by the SEC aroused the agency's interest and led to another jurisdictional battle with the CFTC, which the SEC lost. The SEC then decided to enter derivatives regulation through the back door by creating a broker-dealer "Lite" registration program for broker-dealers that were also derivatives dealers in the over-the-counter market.[215] The SEC required these OTC derivative dealers to establish risk management programs to monitor and manage the risks of their positions. The SEC allowed the OTC derivative dealers to use value at risk systems (VaRs), consistent with the Basel II Accord for banks, which allowed the banks to compute their capital based on the risks in their portfolios.[216] The SEC rules for broker-dealer Lites imposed a capital requirement to prevent "excessive leverage" and cushion steep market declines:

> The final rule contains the minimum requirements of $100 million in tentative net capital and $20 million in net capital. The minimum tentative net capital and net capital requirements are necessary to ensure against excessive leverage and risks other than credit or market risk, all of which are now factored into the current haircuts. Further, while the mathematical assumptions underlying VaR may be useful in projecting possible daily trading losses under "normal" market conditions, VaR may not help firms measure losses that fall outside of normal conditions, such as during steep market declines. Accordingly, the minimum capital requirements provide additional safeguards to account for possible extraordinary losses or decreases in liquidity during times of stress which are not incorporated into VaR calculations.[217]

Broker-dealer Lite registration was not popular until 2004, when the SEC adopted a Consolidated Supervised Entity (CSE) program that allowed large investment banks to change how they computed their capital to meet SEC requirements for capital minimums.[218] That change

214. Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21,286 (Apr. 20, 1993).

215. OTC Derivatives Dealers, 63 Fed. Reg. 59,362 (Nov. 3, 1998)

216. *Id.* at 59,384.

217. *Id.* (footnote omitted).

218. The Securities Exchange Act authorized the SEC to impose capital requirements on broker-dealers (former 15 U.S.C. § 78h(b)). The SEC, however, essentially deferred to the exchanges on that regulation until the paperwork crisis at the end of the 1960s. The SEC then adopted a Uniform Net Capital Rule. 17 CF.R. § 15c3-1. It was a liquidity measure that was designed to ensure that program-

allowed large, highly capitalized broker-dealers to use mathematical models to calculate net capital requirements for market and derivatives-related credit risks.

The SEC's change was in response to a 2002 European Union (EU) directive that required foreign financial services firms with operations in the EU to demonstrate holding company supervision equivalent to EU consolidated supervision. This requirement—known as the Basel II approach—applied to many large broker-dealer operations in the United States.[219] In adopting the Basel II approach, the SEC leveled the playing field for capital requirements among the large competing broker-dealers and banks.[220]

To operate under the new rule, the large broker-dealer investment banks had to consolidate supervision of their ultimate holding company and affiliates. Consequently, such firms were called CSEs.[221] A "broker-dealer may use this 'alternative/CSE' method only if its ultimate holding company agrees to compute group-wide allowable capital and allowances for market, credit, and operational risk in accordance with the standards adopted by the Basel Committee on Banking Supervision" in the Basel II accord. The CSE also had to consent to group-wide SEC supervision, which rarely happened because the SEC did not have the resources to carry out that task.[222]

The SEC required CSEs to follow the broker-dealer Lite risk management procedures, which meant they would use VaR models to determine their capital requirement.[223] Such risk management systems could calculate the market risk and derivatives-related credit risk components of the CSE's net capital requirement, and replace the traditional SEC "haircut" approach to calculating net capital.[224] This program was designed to be a "risk capital" approach to net capital, which was a significant variation from the liquidity test otherwise

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dealers would have sufficient funds on hand to meet customer demands. For a discussion of that complex rule see MARKHAM & HAZEN, *supra* note 38, at ch. 4.

219. Alternative Market Risk and Credit Risk Capital Charges for Futures Commission Merchants and Specified Foreign Currency Forward and Inventory Capital Charges, 70 Fed. Reg. 58,985 (Oct. 11, 2005); *see* Jorge E. Viñuales, *The International Regulation of Financial Conglomerates: A Case-Study of Equivalence as an Approach to Financial Integration*, 37 CAL W. INT'L L. J. 1 (2006) (describing the European Union's Financial Conglomerates Directive and the SEC's response for consolidated supervised entities).

220. For a description of Basel II, see BROOME & MARKHAM, *supra* note 22, at 523–28.

221. Self-Regulatory Organizations, Exchange Act Release No. 34-54255 (July 31, 2006).

222. *Id.*

223. The mathematical models that could be used by a CSE for risk assessment included VaR models and scenario analysis that were already a part of these entities' internal risk management control systems. *See* 17 C.F.R. § 240.17i-4 (2009) (incorporating 17 C.F.R. § 240.15c3-4).

224. Self-Regulatory Organizations, *supra* note 221.

employed in the SEC's net capital rule.[225]

Many of the larger broker-dealers opted for CSE status, including Merrill Lynch, Bear Stearns, Lehman Brothers, and Morgan Stanley.[226] The SEC allowed CSEs to operate with much less capital than commercial bank conglomerates.[227] The CSE system freed up capital for the large firms, but it also reduced their cushion for losses.[228] "Under the traditional [SEC net capital rule] rule, broker-dealers could not exceed a 12-1 [leverage] ratio, but when Bear Stearns became insolvent, its debt-to-capital ratio was 33-to-1; at the time of its merger agreement, Merrill's was reportedly 40-to-1."[229]

The VaR models that allowed this increased leverage failed during the subprime crisis because they relied on historical prices generated by a rising market and overlooked a catastrophic event such as the subprime crisis. These models did not allow for the hundred-year storm, "black swan," "fat tail" outliers that occurred during the subprime crisis.[230] And the rest is history.[231] The failures of Bear Stearns, Lehman

225. 17 C.F.R. § 240.15c3-3 (2009).

226. In 2004, the General Accountability Office noted:

> Mortgage-backed securities grew from about $1,123 billion in 1990 to about $3,796 billion in 2003, while other asset-backed securities grew by a factor of 12 over that same period of time. Because the risk embedded in securitized assets can be structured and priced so that financial institutions and others may be better able to manage credit and interest rate risk with these instruments.
>
> Because banks and insurance companies could reduce their capital requirements by securitizing assets and removing those assets from their balance sheets, securitization was also driven by changes in capital requirements implemented in these industries in the early 1990s that required firms to hold more capital for certain assets.

U.S. GEN. ACCOUNTABILITY OFFICE, INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE 52 (2004), *available at* http://www.gao.gov/new.items/d0561.pdf (footnotes omitted).

227. U.S. GEN. ACCOUNTABILITY OFFICE, *supra* note 64, at 20.

228. John Sandman, *CSE Program: A Failed Experiment*, SEC. INDUS. NEWS, Jan. 19, 2009, *available at* http://www.securitiesindustry.com/issues/19_86/23127-1.html

. 229. *Id.* Risk-based capital models were also adopted by the CFTC, but with better results because they were tied to exchange margin requirements that more accurately valued risks. Minimum Financial and Related Reporting Requirements for Futures Commission Merchants and Introducing Brokers, 69 Fed. Reg. 49,784 (Aug. 12, 2004).

230. Value at risk models failed to account for unusual market events. Those outliers were a well known danger. *See* NASSIM NICHOLAS TALEB, THE BLACK SWAN, THE IMPACT OF THE HIGHLY IMPROBABLE xviii (2007) (describing the dangers of events that have low predictability and large impact and noting that portfolio managers use risk assessment measures that exclude the possibility of a black swan). Some critics contend that the VaR risk management model is too deeply flawed to be of any use in modeling risk. Pablo Triana, No Sense in Reforming VAR, FIN. TIMES (London), Mar. 2, 2009, at 13.

231. It might be more accurate to say that the investment banks that used the broker-dealer Lite system of calculating their capital through VaR models when they became consolidated supervised entities are history.

Brothers, and Merrill Lynch, as well as problems at Morgan Stanley, were blamed on the fact that they had adopted the consolidated supervised unity status.[232] The SEC Inspector General also found that the SEC failed to effectively oversee firms operating under CSE status and to assure that they had sufficient capital.[233]

The SEC admitted on September 26, 2008, that its CSE program was a failure and dropped it.[234] At that point, however, there were no remaining CSEs to supervise. Goldman Sachs and Morgan Stanley had become bank holding companies. Bank of America had acquired Merrill Lynch. Lehman Brothers and Bear Stearns had both failed.[235] But there was hope for the surviving banks. In February 2009, the new Obama Administration announced that it would stress test the largest nineteen banks to determine their survivability. The stress test sought to determine whether the banks could survive the economy contracting 3.3% in 2009 and flat growth in 2010. The stress test would also test the effects of an additional 22% drop in housing prices and an

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232. Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 27, 2008, at A1. Previously, the SEC had applied its net capital rule, a liquidity measure, to those firms. 17 C.F.R. § 15c3-1.

233. *See* U.S. GEN. ACCOUNTABILITY OFFICE, *supra* note 64, at 21.

234. Labaton, *supra* note 232. The SEC Chairman testified before Congress that:

> When the Commission wrote the rules establishing the CSE program in 2004, they chose to rely upon the internationally-accepted Basel standards for computing bank capital. They also adopted the Federal Reserve's standard of what constitutes a "well-capitalized" bank, and required the CSE firms to maintain capital in excess of this 10% ratio. Indeed, the CSE program went beyond the Fed's requirements in several respects, including adding a liquidity requirement, and requiring firms to compute their Basel capital 12 times a year, instead of the four times a year that the Fed requires.
>
> Nonetheless, the rapid collapse of Bear Stearns during the week of March 10, 2008 challenged the fundamental assumptions behind the Basel standards and the other program metrics. At the time of its near-failure, Bear Stearns had a capital cushion well above what is required to meet supervisory standards calculated using the Basel framework and the Federal Reserve's "well-capitalized" standard for bank holding companies.
>
> The fact that these standards did not provide adequate warning of the near- collapse of Bear Stearns, and indeed the fact that the Basel standards did not prevent the failure of many other banks and financial institutions, is now obvious. It was not so apparent before March of this year. Prior to that time, neither the CSE program nor any regulatory approach used by commercial or investment bank regulators in the U.S., or anywhere in the world, was based on the assumption that secured funding, even when backed by high-quality collateral, could become completely unavailable. Nor did regulators or firms use risk scenarios based on a total meltdown of the U.S. mortgage market.

The Financial Crisis and the Role of Federal Regulators: Hearings Before the H. Comm. on Oversight and Gov't Reform, 110th Cong. 5 (2008), *available at* http://oversight.house.gov/images/stories/documents/20081023100525.pdf (testimony of Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n).

235. *See* Adam Zagorin & Michael Weisskopf, *Inside the Breakdown At the SEC*, TIME, Mar. 9, 2009, at 34 (describing these failures and the SEC's failure to respond to this crisis).

unemployment rate of 10.3% in two years. The banks with problems would have six months to raise capital privately. Otherwise the government would buy convertible preferred shares from the banks that would pay a 9% dividend and would convert to common stock as capital was needed from losses. This was the first step in inducing risk models that would test for catastrophic risks.[236]

The government's stress test results for U.S. banks were disclosed on May 7, 2009. Bank of America was found to need $33.9 billion in additional capital; Wells Fargo required $13.7 billion; Citigroup $5.5 billion; and Morgan Stanley $1.8 billion. Those not needing additional capital included JPMorgan Chase, Goldman Sachs, Bank of New York Mellon, and American Express.[237] Critics claimed that the government had weakened its stress tests in response to demands from the banks that were being tested. Among other things, the banks were allowed to value distressed collateralized debt obligations (CDOs) by cash flow, rather than marking them to market. Nevertheless, the test results seemed to have restored the market's confidence in financial institutions, and the banks needing additional capital were able to raise it in the market.[238]

B. Long-Term Capital Management

When adopted, the CFTC viewed the SEC's broker-dealer Lite program as an encroachment on its turf. In response, the CFTC proposed to study whether it should expand its own jurisdiction over the burgeoning OTC derivates market; both Congress and the industry opposed the study. Additionally, Robert Rubin, the Secretary of the Treasury, Alan Greenspan, Chairman of the Federal Reserve Board, and Arthur Levitt, Chairman of the SEC, blasted the CFTC's proposal.[239]

In the midst of that contretemps, a huge hedge fund, Long Term Capital Management (LTCM), which had been investing in derivatives,

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236. Edmund L. Andrews & Eric Dash, *Treasury Sets Out Bank Test Guidelines*, N.Y. TIMES, Feb. 26, 2009, at B1.

237. *How the Stress Tests Stopped the Market Bleeding*, WALL ST. J., May 8, 2009, at C1. The Dow rose on that news to 8512.28, but it later appeared that the government had weakened its stress tests in response to demands from the banks that were being tested. Morgan Stanley responded quickly to the government's demand that it increase its capital through a $4 billion offering on May 8, 2009. Wells Fargo raised $7.5 billion in equity on the same day. Even Citigroup was able to raise $2 billion on May 15, 2009, through sale of non-government backed bonds. Bank of America also quickly raised a large amount of capital. Jack Healy & Edmund L. Andrews, *Bank System Is Healing, Geithner Tells Senators*, N.Y. TIMES, May 21, 2009, at B3.

238. David Enrich et al., *Fed Sees Up to $599 Billion in Bank Losses*, WALL ST. J., May 8, 2009, at A1; Deborah Solomon, *Nine Banks to Repay TARP Money Today*, WALL ST. J., June 9, 2009, at C3.

239. David Barboza & Jeff Gerth, *Who's in Charge? Agency Infighting and Regulatory Uncertainty*, N.Y. TIMES, Dec. 15, 1998, at C14.

suffered massive losses in September 1998. Those losses raised concerns that LTCM might fail and touch off a market panic. The Federal Reserve Board intervened and pressured some large broker-dealers to infuse capital into LTCM to stop any panic—which they did.[240] The CFTC used that event to support its claim that it should regulate OTC derivatives.[241] Congress did not accept the CFTC's argument and responded in November 1998 with a legislative moratorium that prohibited the CFTC from asserting regulatory control of the OTC derivatives market.[242]

C. Commodity Futures Modernization Act of 2000

Congress directed the Presidential Working Group on Financial Markets to study the OTC derivatives market and recommend whether Congress should regulate it. That report was issued in 1999[243] and was followed by the CFMA, which[244] exempted OTC instruments from regulation where the transactions' parties were sophisticated. The exempted institutions included banks, investment bankers and other financial institutions, pension funds, large businesses, and high net worth individuals. The Treasury Department noted that:

> The primary justifications for recommending exclusion for such transactions were a determination that most OTC financial derivatives (e.g., interest rate swaps) were not susceptible to manipulation and that the counterparties in such transactions did not need the same protections as smaller, unsophisticated market participants who relied on intermediaries to conduct their transactions.[245]

After its leadership changed, the CFTC abandoned its traditional

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240. *See* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000) (describing that event). The failure of LTCM raised concerns at the Federal Reserve Board that it might present systemic dangers, and a rescue was arranged by the New York Federal Reserve Bank in which several large investment banks invested funds in that hedge fund. This created much controversy because it was thought that the Fed was signaling that it would rescue any large investor caught in a liquidity trap or that was faced with unexpected losses. That rescue was called the "Greenspan put." ETHAN S. HARRIS, BEN BERNANKE'S FED: THE FEDERAL RESERVE AFTER GREENSPAN 71 (2008).

241. David Barboza & Jeff Gerth, *On Regulating Derivatives*, N.Y. TIMES, Dec. 15, 1998, at C1.

242. This bar was included in the Omnibus Appropriations Act. It temporarily prohibited the CFTC from issuing any interpretation of policy statements that would regulate activity in a hybrid instrument or swap agreement. Comm. Fut. L. Rep. (CCH) ¶ 27,431 (C.F.T.C. 1998).

243. PRESIDENT'S WORKING GROUP ON FIN. MKTS., OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT (1999), *available at* http://www.treas.gov/press/releases/reports/otcact.pdf.

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

245. TREASURY BLUEPRINT, *supra* note 8, at 47.

rules-based regulatory structure in favor of a principles-based system[246] The CFMA also created a multi-tiered derivatives market in which each tier was subject to differing levels of oversight based on the nature of the participants, the commodity traded, and the type of trading. The most regulated tier was the traditional contract market where retail traders participated, but even it was transitioned to a principles-based regimen, which allowed the exchanges more control over their operations. The CFMA did leave traditional "designated contract markets" (DCMs) saddled with cumbersome regulatory requirements, while upstart electronic execution facilities remained virtually unregulated.

The DCMs were required to continue as self- regulatory bodies in conjunction with the NFA.[247] But the DCMs and the NFA did not consolidate their self-regulatory activities, as did the NYSE and NASD when they created FINRA. But the DCMs and NFA did form a Joint Audit Committee to better monitor and examine common member futures commission merchants.[248]

The CFMA also exempted electronic trading facilities used by institutional traders from regulation; these facilities were called "exempt commercial markets" (ECMs). ECMs must restrict trading through their electronic facilities to principal-to-principal transactions between "eligible commercial entities." These eligible commercial entities are large institutional traders, and include hedge funds that trade "exempt" commodities, which included energy products, metals, chemicals, and emission allowances. ECMs became popular and even challenged traditional DCMs for market share.[249]

D. More Overlapping Regulation

Following the Enron scandal, the Federal Energy Regulatory Commission (FERC) brought a number of actions in California under its power to regulate natural gas and electricity.[250] This raised concerns as to whether the FERC was intruding into the CFTC's regulation area.

246. A New Regulatory Framework, Comm. Fut. L. Rep. (CCH) ¶28,036 (C.F.T.C. 2000).

247. *Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets: Hearing Before the CFTC* (2007), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opaarbit_091807.pdf (testimony of Terry S. Arbit, Gen. Counsel, CFTC).

248. Joint Audit Committee Operating Agreement, Comm. Fut. L. Rep. (CCH) ¶30,908 (September 11, 2008).

249. *See Hearing to Examine Trading on Regulated Exchanges and Exempt Commercial Markets: Hearing Before the CFTC*, *supra* note 247 (testimony of Terry S. Arbit, Gen. Counsel, CFTC) (describing these facilities).

250. *See* MARKHAM, *supra* note 58, at 62. (describing those actions).

Congress, however, encouraged FERC's efforts by passing the Energy Policy Act of 2005, which expanded the FERC's powers to attack energy price manipulations.[251] That legislation essentially adopted the anti-manipulation language of the Securities Exchange Act of 1934, rather than the Commodity Exchange Act's more complex and difficult-to-prove language.[252]

It was undecided whether the FERC's jurisdiction extended to transactions in the commodity futures markets, where the CFTC had traditionally had exclusive jurisdiction. In October 2005, the CFTC and FERC adopted a memorandum of understanding (MOU) agreeing to refer to the other potential violations that were within the jurisdiction of the other agency where futures contracts were involved in suspected energy price manipulations. The FERC was also permitted to access information from commodity exchanges if necessary for its investigations.[253]

The MOU was in double jeopardy from regulatory actions by both FERC and the CFTC. This proved to be the case in simultaneous actions filed by both the CFTC and FERC against Energy Transfer Partners L.P., which was charged with violating the antimanipulation statutes—administered by both agencies—while trading natural gas.[254] The advantage of two government agencies bringing actions against the same company for the same conduct remains unclear. It is an especially troubling policy because government agencies regularly claim they do not have the resources to carry out their missions.

Despite the MOU, a related high-profile case created a jurisdictional conflict between the CFTC and FERC. In September 2006, a large hedge fund, Amaranth Advisors, LLC, lost more than $6 billion during a single week trading energy products.[255] The CFTC and FERC brought separate cases against Amaranth and two of its traders charging energy price manipulation.[256] The district court in the CFTC action noted: "Hence, Amaranth is being pursued by two federal regulatory agencies

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251. Pub. L. No. 109-58, 119 Stat. 594.

252. *See* Markham, *supra* note 149, at 288–98 (describing the difficulties with the CFTC manipulation standard).

253. Commodity Futures Trading Comm'n v. Amaranth Advisors, LLC, 523 F. Supp.2d 328, 332–33 (S.D.N.Y. 2007).

254. Maya Jackson Randall, *FERC Accuses Amaranth of Manipulation*, WALL ST. J., July 27, 2007, at C6.

255. Jeanine Prezioso, *Natural-Gas Futures End Session Mostly Lower*, WALL ST. J., Sept. 23, 2006, at B5.

256. The Amaranth affair is described more fully in Jerry W. Markham & Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 J. CORP. L. 865, 879–80 (2008).

in two separate proceedings in two different jurisdictions, based on the same alleged conduct."[257] Amaranth claimed that the CFTC had exclusive jurisdiction over manipulation claims in the futures markets, but the FERC claimed that its jurisdictional mandate under the Energy Policy Act of 2005 was not so limited. The district court refused to enjoin the FERC action though it sympathized with the defendant's plight. Another federal district court made a similar ruling in another duplicative action by the CFTC and FERC.[258]

The Amaranth failure raised other issues. The New York Mercantile Exchange (NYMEX) had forced Amaranth to reduce its positions on the exchange before Amaranth's large loss, so using a regulatory arbitrage, Amaranth shifted its positions to the unregulated market on the IntercontinentalExchange (ICE), an electronic exchange located in Atlanta, Georgia.[259] ICE had become a major global marketplace for trading futures and OTC energy derivative contracts after Enron collapsed. It operated an electronic trading platform for institutional traders in the United States that was an ECM, and supposedly exempt from CFTC regulation. But as energy prices spiked, and the size of Amaranth's natural gas trading was revealed, ICE became a focal point of regulatory concerns. Crude oil prices were also concerning. Oil reached $70 a barrel on April 17, 2006, and then jumped to $75 a barrel, pushing prices at the pump to more than $3 a gallon. Eventually, crude oil peaked at $147.27 per barrel in July 2008,[260] pushing gasoline to more than $4 a gallon.[261] This price explosion set off shockwaves throughout the economy.[262]

In 2006, Congress directed the FTC to determine if gasoline refiners, large wholesalers, and retailers had "price gouged" in the wake of Hurricane Katrina. Congress also instructed the FTC to investigate whether gasoline prices nationwide were artificially manipulated by reducing refinery capacity or by any other form of market manipulation. The FTC's May 2006 report found no instances of illegal market manipulation, but found fifteen examples of what initially appeared to be "price gouging." Other factors, however, such as regional or local

257. *Amaranth Advisors*, 523 F. Supp.2d at 331–32.

258. *See* Hunter v. Fed. Energy Regulatory Comm'n, 527 F. Supp. 2d 9 (D.D.C. 2007).

259. S. PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. AND GOVERNMENTAL AFFAIRS, STAFF REPORT: EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET 6 (2007).

260. *S&P 500 Drops Into Bear Market*, *supra* note 4.

261. Jad Mouawad, *Bright Sliver in Grim Economy as Energy Prices Take a Break*, N.Y. TIMES, July 30, 2008, at A1.

262. Russell Gold & Guy Chazan, *For Big Oil Firms, a Silver Lining*, WALL ST. J., Oct. 23, 2008, at B2.

market trends, appeared to explain those prices.[263] The FTC report also stated that any federal gasoline price-gouging legislation would be unenforceable and could cause more problems for consumers than it would solve. The report also concluded that competitive market forces should determine the price of gasoline at the pump, but the FTC's explanation that market forces were driving energy prices was ignored.[264]

Although the FTC seemed uninterested in pursuing an energy witch hunt, a GAO report in 2007 on derivative trading in the energy markets questioned the CFTC's oversight ability.[265] Congress responded by granting the FTC overlapping authority to prosecute false reporting and market manipulation in the wholesale petroleum market.[266] This charged three agencies with regulating trading in the energy markets—the CFTC, FERC, and FTC, as well as the Justice Department for criminal prosecutions.

Concerns continued as energy prices peaked in 2008 and led to an interagency task force to determine what was driving up crude oil prices. The CFTC chaired that task force, which included representatives from the Departments of Energy, Agriculture, and Treasury, as well as the Federal Reserve Board, FTC, and SEC. The task force, which released its report in July 2008, concluded that oil price increases between 2003 and 2008 were largely the result of supply and demand, rather than speculation. The report found that the crude oil futures market grew significantly during that period, but the agencies preparing the report did not find support for the proposition that speculative activity had systematically driven changes in oil prices.[267] The task force also confirmed the obvious, that an imbalance between supply and demand led to price increases.[268] This conclusion did not satisfy some members of Congress, who continued to blame unknown speculators and bogeymen for the phenomenal rise in energy prices.

263. FED.TRADE COMM'N, INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GASOLINE PRICE INCREASES (2006), *available at* http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf.

264. *Id.*

265. U.S. GEN. ACCOUNTABILITY OFFICE, TRENDS IN ENERGY DERIVATIVES MARKETS RAISE QUESTIONS ABOUT CFTC'S OVERSIGHT (2007).

266. Energy Independence and Security Act of 2007, §§ 811-815, Pub. L. No. 110-140, 121 Stat. 1492 (codified as amended at 42 U.S.C. 17301–17305 (2006)).

267. INTERAGENCY TASK FORCE ON COMMODITY MARKETS, INTERIM REPORT ON CRUDE OIL (2008).

268. *Id.*

E. Enron Loophole

The CFTC asked Congress for more regulatory authority over ECMs, and expanded reporting requirements over ECMs.[269] The CFTC was particularly interested in the ECMs because of their growing role in the high-profile energy markets. The ECM exclusion was often referred to as the "Enron loophole," or "Enron exemption," because it was inserted into the CFMA at the last minute through Enron's lobbying efforts, which was seeking to protect its popular electronic trading platform, EnronOnline, from regulation.[270] After Enron imploded, the exemption became suspect. Though other trading operations exploited the ECM exemption to create a viable OTC institutional trading market—as demonstrated by ICE's success—the lack of regulation in those markets made them suspicious.

Congress closed the Enron loophole through amendments included in the CFTC Reauthorization Act of 2008.[271] The amendments may be referred to as the "ICE amendments" because of concerns with trading in energy contracts on that exchange raised by the Amaranth regulatory arbitrage. The new amendments sought to close the Enron exemption by subjecting ECMs to CFTC position limits, recordkeeping requirements, and large trader reporting requirements where the CFTC determined that an ECM was trading a "significant price discovery contract" (SPD). A SPD is a contract traded on an otherwise exempt ECM that has a price

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269. Market Growth Trader Participation and Pricing in Energy Futures Markets, Com. Fut. L. Rep. (CCH) ¶30,451 (CFTC 2007). The new CFTC chairman Gary Gensler, appointed by the Obama Administration disavowed the CFTC's conclusion that market forces not speculators were creating volatility in the energy markets. He proposed position limits on the size of trading. Kara Scannell & Sarah N. Lynch, *CFTC Hopes to Tame Rocky Energy Markets*, WALL ST. J., Jan. 14, 2010 at C3; Dwight Cass & Lauren Silva Laughlin, *Energy Traders on the Firing Line*, N.Y. TIMES, July 8, 2009, at B2.

270. *See* S. PERMANENT SUBCOMM. ON INVESTIGATIONS OF THE COMM. ON HOMELAND SEC. AND GOVERNMENTAL AFFAIRS, *supra* note 259, at 41, 44. Enron played a leading role in pushing the commodity markets toward electronic trading. EnronOnline was launched in 1999 as an Internet trading platform for energy products. EnronOnline provided real-time quotes posted by Enron traders for wholesale customers. There was no human interface in the transactions effected on EnronOnline. Enron acted as a principal in the transactions being quoted, which provided Enron with a considerable competitive advantage because no one outside the company was aware of the spreads being charged by the Enron traders. In 2000, Enron Online made 548,000 transactions with a notional amount of $336 billion. MARKHAM, *supra* note 58, at 62.

271. The CFTC Reauthorization Act of 2008 was enacted as Title XIII of the Food, Conservation, and Energy Act of 2008 (Farm Bill), Pub. L. No. 110-246, 122 Stat. 1651 (2008). That legislation was passed over a presidential veto on May 22, 2008. Because of a clerical error, however, one of the titles in the bill was inadvertently omitted in the version vetoed by the President. An embarrassed Congress then voted to present a complete version of the legislation to President Bush and it was passed over his second veto on June 18, 2008. *Congress passes farm bill over Bush veto*, CNN, June 18, 2008, http://www.cnn.com/2008/POLITICS/06/18/farm.bill/index.html.

linkage to contracts traded on a regulated contract market or is used as a material price reference to price transactions in the underlying commodity.[272]

The ICE amendments required the CFTC to monitor trading in SPDs. The legislation now regulates ECMs trading SPDs in much the same manner as regulated contract markets. The ECM must comply with nine core principles that, among other things, requires ECMs to take steps to prevent price manipulation, provide information to the CFTC upon request, adopt rules imposing speculative position limits, and publish daily price and volume information on SPDs. Large traders on an ECM trading in SPDs are also required to report their trades to the CFTC.[273]

VI. MARKET CONVERGENCE

A. Toward a Single Market

Because the CFTC and SEC are widely viewed as failed regulators, merging them may be like merging two failing businesses in the hope that it would make one strong entity. Combining failure with failure does not seem like a formula for success. Perceptions that the agencies are failures suggest that regulatory reform is necessary. And merging failing entities does have a favorable effect where over capacity is an issue. But a more compelling reason for consolidating the two agencies is that the markets regulated by the CFTC and SEC have converged. This convergence has been underway for sometime. The Brady Commission found that, by 1987, the two markets were interrelated and reactive to each other.[274] Additionally, financial products underlie most trading on commodity futures exchanges.[275] The Treasury Blueprint merger recommendation was based on its belief that because of the "convergence of the futures and securities markets," the SEC and CFTC should be consolidated into a single agency.[276]

The CFMA also supported convergence when it addressed trading in single stock futures. Futures trading was previously proscribed on single stocks because of SEC concerns that such instruments could be used to manipulate the underlying stock's price, but Congress eventually

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272. Significant Price Discovery Contracts on Exempt Commercial Markets, 73 Fed. Reg. 75,888, 75,891 (Dec. 12, 2008) (proposed rules).

273. *Id.*

274. MARKET MECHANISMS, *supra* note 192, at vii.

275. Susan Carey & Joseph T. Hallinan, *Chicago Exchanges Combine Thunder—Merger May Set the City's Status as the Derivatives Showplace, Ending a Century-Old Rivalry*, WALL ST. J., Oct. 18, 2006, at C1.

276. TREASURY BLUEPRINT, *supra* note 8, at 106.

reached a compromise that allowed single stock futures to be traded under joint regulation by the SEC and CFTC.[277] Now single stock futures trading is handled jointly by broker-dealers on securities exchanges and futures commission merchants on commodity exchanges.

Further evidence of a convergence is found in the CFTC approval of the designation of Island Futures Exchange, LLP (now the Inet Futures Exchange, LLC) as a contract market in February 2002, allowing it to trade single stock futures.[278] That entity was affiliated with the Island electronic securities trading platform. The CBOE, traditionally regulated as a securities exchange, created a DCM subsidiary in 2004 (CBOE Futures Exchange, LLC), which trades futures contracts based on "variance" and "volatility"—a particularly popular product during the height of the subprime crisis. The CFTC regulates that DCM.[279]

The Philadelphia Stock Exchange, another exchange traditionally regulated by the SEC, created a DCM subsidiary, the Philadelphia Board of Trade, that trades currency and financial futures in sector indexes; it was acquired by NASDAQ, renamed the NASDAQ OMX Futures Exchange, and trades IDEXTM USD (interest rate swap futures), world currency futures, and sector index futures.[280] NASDAQ OMX created an energy-trading platform in October 2008.[281] NYSE-Euronext created a subsidiary, NYSE Liffe, LLC, which, in turn, purchased the CBOT's precious metals futures operations after the merger of the Chicago Mercantile Exchange (CME) and the CBOT with the NYMEX, which had a competing precious metals futures business.[282] NYSE-Euronext also planned to expand its futures offerings to include various indexes.[283]

B. Avoiding a Merger

That the markets converged, on its face, seems to support merging the

277. Customer Margin Rules Relating to Security Futures, Exchange Act Release No. 34-4853, 45 SEC Docket 2030 (Sept. 26, 2001).

278. The Island Futures Exchange was dually registered as a national securities exchange with the SEC. Acknowledgement of Receipt of Notice of Registration as a National Securities Exchange Pursuant to Section 6(g) of the Securities Exchange Act of 1934 by the Island Futures Exchange, LLC, Exchange Act Release No. 34-47407, 79 SEC Docket 2025 (Feb. 26, 2003).

279. *See* Steven R. Strahler, *CBOE to found futures exchanges*, CHI. BUS., Jan. 27, 2004, http://www.chicagobusiness.com/cgi-bin/news.pl?id=11317.

280. *See* Nasdaq OMX, NFX Overview, http://www.nasdaqtrader.com/Micro.aspx?id=PBOToverview.

281. Doug Cameron, *Nasdaq to Get In on Emissions Contracts*, WALL ST. J., Oct. 22, 2008, at C5.

282. NYSE Euronext, NYSE Liffe U.S., http://www.nyse.com/futuresoptions/nyseliffe/1211983444453.html.

283. *What's News*, WALL ST. J., May 26, 2009, at A1.

regulation of the markets. But even before the Treasury Blueprint was published both the SEC and CFTC were laying the groundwork to support their jurisdiction. The two agencies announced a memorandum of understanding in March 2008 for coordinating their activities to avoid duplication and unnecessary costs.[284] This agreement was in anticipation of the Treasury Blueprint—which was issued a few weeks later—and in the hope that it would defuse the Treasury's recommendation to combine the two agencies.

The SEC and CFTC also agreed to principles for how to regulate new financial instruments, so that past jurisdictional strife would not be used to justify consolidation.[285] Pursuant to that agreement, the CFTC and SEC jointly acted in June 2008 to allow trading of options (regulated by the SEC) and futures (regulated by the CFTC) on exchange-traded funds (ETFs) that were traded on stock exchanges regulated by the SEC.[286] This was rare cooperation between the two agencies. Typically, as one industry leader has noted:

> Any novel derivative that hints of a futures contract must be vetted by the SEC and the CFTC as to its legal status. The result often is an interminable delay as the two agencies try to decide which has jurisdiction over the product.
>
> For example, our exchange, the Chicago Board Options Exchange, filed a proposal in June 2005 with the SEC to trade options on exchange-traded funds that invest in gold. The proposal has gone nowhere because the SEC and CFTC are still trying to decide, more than two years later, who should regulate the product. Markets overseas do not have this problem and, as a result, often trade new derivative products long before they are available in the U.S.[287]

This cooperation did not last long. Attitudes hardened as the subprime crisis worsened and regulators came under criticism. Inexplicably, the credit default swap (CDS) market touched off a war over regulatory jurisdiction. A CDS is an agreement by one party to make a series of payments to a counterparty in exchange for a payoff, if a specified credit instrument goes into default. A CDS can be used as a form of insurance against a default from that credit instrument. It can

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284. *Full Committee Hearing to Consider the Following Nominees to CFTC Positions: Hearing Before the S. Comm. on Agriculture, Nutrition & Forestry*, 110th Cong. 2, *available at* http://216.40.253.202/%7Eusscanf/index.php?option=com_docman&task=doc_download&gid=13 (testimony of Walter Lukken).

285. *See* Press Release, CFTC, CFTC, SEC Sign Agreement to Enhance Coordination, Facilitate Review of New Derivative Products (Mar. 11, 2008), *available at* http://www.cftc.gov/newsroom/generalpressreleases%20/2008/pr5468-08.html.

286. Exemption Letter, 2008 WL 351339 (CFTC Jan. 29, 2008).

287. William J. Brodsky, *A Real Regulatory Redundancy*, WALL ST. J., Oct. 19, 2007, at A19.

also be used for speculation on whether a default will occur. During the subprime crisis, concerns arose over defaults and systemic dangers from this opaque market because the CDS market had an outstanding notional amount of $55 trillion in 2008.[288]

The failure of Bear Stearns was blamed on CDS exposures. When it failed, Bear Stearns had an estimated $2.5 trillion in outstanding CDSs.[289] Lehman Brothers' failure raised additional concerns that CDSs written on its debt obligations could generate catastrophic claims. Early estimates were that $400 billion in CDSs were written on Lehman Brothers debt, but in the end *only* $6 billion was paid to protection buyers.[290] Although there were no disastrous problems from the Lehman Brothers failure in the CDS market,[291] the U.S. government had to rescue American International Group (AIG) and pay AIG's massive CDS obligations.[292]

Before he was replaced, SEC Chair Christopher Cox requested legislation to allow the SEC to regulate the CDS market and provide "transparency"—a watchword for regulation.[293] But no one could explain how transparency could have prevented the subprime crisis. Worse still, nobody asked that question, but simply clamored for transparency without asking whether it would prevent future crises. In response to default concerns, federal regulators began pressuring the industry to form a central clearinghouse to guarantee performance and transparency.[294] This soon turned into a competition among the larger exchanges to grab this market by creating a central clearinghouse.[295] Swap dealers supported the effort to create a credit default swap clearinghouse and pledged to have such a facility in place by year-end

288. Carrick Mollenkamp, et al., *Lehman's Demise Triggered Cash Crunch Around Globe*, WALL ST. J., Sept. 29, 2008, at A1.

289. Nelson D. Schwartz & Julie Creswell, *What Created This Monster?*, N.Y. TIMES, Mar. 23, 2008, at BU1.

290. Deborah Lynn Blumberg, *It's Wait and See for Bond Traders*, WALL ST. J., Oct. 13, 2008, at C2.

291. L. Gordon Crovitz, Opinion, *Credit Panic: Stages of Grief*, WALL ST. J., Oct. 27, 2008, at A17; *Credit Default Swamp*, WALL ST. J., Jan. 3, 2009, at A8.

292. Carrick Mollenkamp, et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J. Nov. 3, 2008, at A1.

293. *See* Christopher Cox, *Swapping Secrecy for Transparency*, N.Y. TIMES, Oct. 19, 2008, at WK12.

294. The new Obama Administration was reported to be preparing a proposal to require such clearing. Stephen Labaton, *Obama Plans Fast Action To Tighten Financial Rules*, N.Y. TIMES, Jan. 25, 2009, at A1.

295. Doug Cameron & Kara Scannell, *Regulators Back System to Clear Credit Swaps*, WALL ST. J., Dec. 24, 2008, at C1; Sarah N. Lynch & Jacob Bunge, *ICE's Swaps Plan Is Advancing*, WALL ST. J., Jan. 14, 2009, at C14.

2008.[296] This process was soon bogged down in jurisdictional fights among the SEC, CFTC, and New York Federal Reserve Bank. Though these entities accepted a memorandum of understanding in November 2008 that was supposed to settle their differences,[297] the process remained mired by the need to obtain multiple regulatory approvals.[298]

Finally, the SEC again intruded on the CFTC's turf after Birmingham, Alabama's county government lost $200 million on interest-rate swaps in February 2008. The SEC sued Larry Langford, the Mayor of Birmingham, for accepting more than $150,000 from a friend who was an employee of an investment banking firm that received $6.7 million in fees from swap contracts and municipal bond offerings by the city. The case was the SEC's first enforcement action involving security-based swap agreements.[299]

VII. THE CFTC AND SEC—CULTURAL DIFFERENCES

A. Basis for Differences

The vast cultural divide between the regulatory approaches taken by the CFTC and SEC became clear even before the CFTC was created. In 1968, the General Accounting Office (GAO) concluded that floor traders ("locals") had time and place advantages over the public traders using the markets. The GAO noted that the SEC had required the securities exchanges to create plans to eliminate floor traders, an action taken after an extensive study by the SEC. The GAO urged the Commodity Exchange Authority to conduct a similar study. The Commodity Exchange Authority resisted that request, but did eventually conduct a small study on the NYMEX, concluded that floor traders were providing a valuable price-stabilizing function on that commodity exchange and

296. Jacob Bunge & Doug Cameron, *Crisis on Wall Street: ICE to Buy Clearing Corp. As Big Banks Support Plan*, WALL ST. J., Oct. 31, 2008, at C2.

297. Doug Cameron & Jacob Bunge, *Crisis on Wall Street: Regulatory Troika Heads Off Swap Turf War*, WALL ST. J., Nov. 15, 2008, at B6. The New York insurance department was also seeking to regulate credit default swaps, but backed off that plan as momentum for a federally regulated clearinghouse grew. Sarah N. Lynch, *Crisis on Wall Street: New York Will Suspend Its CDS Plan*, WALL ST. J., Nov. 21, 2008, at C2.

298. The agencies continue to clash.

> For example, when Sentinel Management Group experienced problems this summer, the SEC and the CFTC clashed in court as to how to dispose of client funds held by Sentinel. The judge in the matter asked, "Why doesn't this agency of government go over and talk to this [other] agency of the government and get your act together, for crying out loud?"

Brodsky, *supra* note 287.

299. Sec. & Exch. Comm'n v. Langford, Litigation Release No. 20545, 93 SEC Docket 416 (April 30, 2008).

were not dominating the market. Consequently, the Commodity Exchange Authority concluded that further action on such concerns was unnecessary.[300]

This cultural divide became clearer after the CFTC was created. The Commodity Exchange Authority used Department of Agriculture lawyers to handle its cases. The CFTC, therefore, had to create its own legal staff, and it recruited a number of SEC and SEC alumni lawyers.[301] But the pro-regulatory stance of those SEC-trained lawyers conflicted with the hands-off regulatory attitude of the Commodity Exchange Authority staff and the commodity futures exchanges.

That culture clash was epitomized by an effort by the former SEC lawyers to convince the CFTC to pass customer protection rules that would have included, among other things, a requirement that futures brokers not recommend transactions that were not "suitable" for customers. This was a centerpiece of the SEC's regulation of broker-dealers in the securities industry. After much industry opposition, the CFTC rejected that proposal. Instead, it required futures commission merchants to provide customers with a one-page risk disclosure document that warned of the dangers of commodities contracts and advised prospective customers to consider whether they were suitable for such transactions. This placed the suitability burden on the customer, rather than the broker.[302]

Other significant differences in their regulatory approach would make integrating the SEC and CFTC into a single agency difficult. Prime among those differences are their diverging views on margin.[303] Congress included a provision in the Securities Exchange Act of 1934 that allowed the Federal Reserve Board to set stock margin levels, and it directed the SEC to enforce those requirements.[304] The Fed subsequently issued Regulation T, which set most stock margins at 50%. Although the federal government has tried to impose control, margins on

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300. MARKHAM, *supra* note 150, at 51–52.

301. The author was one of those lawyers.

302. MARKHAM, *supra* note 150, at 56–65.

303. The Treasury Blueprint notes:

> In general, margin is a very different concept in the futures and securities worlds. In the securities context, margin means a minimum amount of equity that must be put down to purchase securities on credit, while in the futures context margin means a risk-based performance bond system which acts much like a security deposit. With respect to portfolio margining, the CFTC and the SEC are in agreement in principle, but have been unable to overcome certain legal impediments and philosophical differences to agree on a single approach.

TREASURY BLUEPRINT, *supra* note 8, at 116.

304. *See* 15 U.S.C. § 78g (2006).

futures contracts are set by the exchanges, not the government. The futures industry has stoutly resisted efforts to impose federal controls over margin and continued to do so during the subprime crisis, even as energy and other commodity prices skyrocketed.[305]

B. Other Differences

The SEC has concentrated much of its enforcement efforts on stopping insider trading, albeit without much success. Insider trading was previously legal under state laws,[306] and the SEC did not argue that federal securities laws prohibited it. But in 1961, SEC Chair William Carey established that insider trading was illegal, through a settlement in an SEC administrative proceeding with Cady, Roberts & Co.[307] In that action, the SEC required "equal access to information" for all traders, and the violation of such as the basis for its insider trading charges. That theory ignores the fact that access to information in the real world is asymmetrical. The SEC, nevertheless, used that 1961 settlement as leverage to sell its "equal access" theory to the Second Circuit, which eagerly accepted it.[308] Although the Supreme Court was not so accepting of the equal access theory,[309] it did eventually adopt the SEC's hastily improvised "misappropriation theory" as an alternative for prosecuting insider trading.[310] Insider trading has since become a centerpiece of the SEC's regulatory program.

In contrast to the SEC, the CFTC, after conducting a congressionally mandated study on insider trading in the commodity markets, concluded in 1984 that it would not pursue the SEC's course for insider trading.[311] This was because most information used in trading derivatives involves "market" information, rather than inside information about a public corporation. The CFTC believed that traders should freely use such market information to better price commodities. The CFTC recognized that market information is asymmetrical and believed that better pricing

305. Markham, *supra* note 199, at 101–23.

306. *See* Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933). *Compare* Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (no insider trading prohibition in Indiana, even today) *with* Diamond v. Oreamuno, 248 N.E.2d 910 (N.Y. 1969) (New York court created insider trading prohibition).

307. *In re* Cady, Roberts & Co., 49 S.E.C. 907 (1961).

308. Sec. & Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968).

309. Chiarella v. United States, 445 U.S. 222 (1980).

310. United States v. O'Hagan, 521 U.S. 642 (1997).

311. CFTC, A STUDY OF THE NATURE, EXTENT AND EFFECTS OF FUTURES TRADING BY PERSONS POSSESSING MATERIAL, NONPUBLIC INFORMATION (1984). The CFTC also rejected the SEC's misappropriation theory in that report, but later brought an action against two traders who were stealing information from their employer concerning trading plans that had market effect. Commodity Futures Trading Comm'n v. Kelly, Comm. Fut. L. Rep. (CCH) ¶27,465 (S.D.N.Y. 1998).

was more likely when traders are induced by the possibility of profit to bring the information into the market by signaling with their trades. That view was adopted by 2008 amendments to the Commodity Exchange Act.[312]

The Treasury Blueprint noted other distinctions in the two agencies' regulatory approaches. For example, customers of broker-dealers regulated by the SEC are protected by the SIPC, which insures account balances and up to $500,000 from losses caused by the broker-dealers. There is no such protection in the futures industry. Indeed, the CFTC rejected such account insurance as unnecessary[313] because futures industry customers are protected in bankruptcy by priority over other creditors for funds held in segregated accounts.[314]

There are also cultural differences that divide the securities and derivatives industries. The derivatives industry, led by the commodity futures exchanges in Chicago, has long resisted regulation. The commodity markets were virtually unregulated under the Commodity Exchange Authority and only lightly regulated after the CFTC was created—at least compared with the securities industry. The futures industry culture advocates free enterprise and market discipline and opposes government regulation.

In contrast, the securities industry has embraced regulation and generally supported the SEC, which has developed a large network of alumni that promote its regulatory approach. Many securities industry participants believe that regulation lends credibility not otherwise available. Futures industry participants generally do not believe that they need intrusive regulation to gain credibility. Rather, the futures industry would rather have that burden self-imposed by a freely competitive environment that would economically punish wrongdoers more efficiently than government regulators. The Chicago Mercantile Exchange even portrayed itself as a bastion against communism in one advertising campaign.

Combining the SEC and CFTC raises other concerns. The SEC has historically viewed securities markets as one-sided—buy side. In

312. The amendments stated that nothing in the antifraud provision in the Commodity Exchange Act section should be read to require any person to disclose "nonpublic information that may be material to the market price, rate, or level of the commodity or transaction, except as necessary to make any statement made to the other person in or in connection with the transaction not misleading in any material respect." 7 U.S.C. § 6b(b) (2006). This amendment appears to take the approach adopted by the Supreme Court in 1817 when it held that inside information need not be disclosed about a commodity being bought and sold, but prohibited affirmative misrepresentations. Laidlaw v. Organ, 15 U.S. (2 Wheat) 178 (1817).

313. MARKHAM, *supra* note 150, at 10.

314. TREASURY BLUEPRINT, *supra* note 8, at 117.

contrast, futures traders recognize that markets go up and down. Short sellers are viewed to be as important as the long sellers in the price discovery process in the commodity markets.[315] In contrast, the SEC has historically viewed short selling as inherently manipulative.[316] That view led to another embarrassment for the SEC during the subprime crisis when it restricted short selling.[317] For years the SEC had imposed a "tick test," allowing short sales only on an uptick in a stock's price.[318] The SEC dropped that requirement when it adopted Regulation SHO in 2004.[319] This move away from the tick test was generally considered an advance for the SEC in recognizing that markets may be traded on both long and short sides. But during the subprime crisis, large investment banks such as Lehman Brothers, Morgan Stanley, Citigroup, and Bear Stearns claimed that short sellers were knocking down their stock prices.

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315. Not everyone agreed with this position. Members of Congress sought to limit or abolish short selling during consideration of the legislation that became the Commodity Exchange Act of 1936 . *See* 80 CONG. REC. 7857 (1936) (remarks of Senator Murray); H.R. REP. No. 72-1551 (1932).

316. As the Treasury Blueprint noted:

> A short sale in the securities context is usually depicted as a risky bet that stock prices will decline. Moreover, some observers contend that heavy short-selling deliberately to drive down the price of a stock may constitute manipulation. In contrast, short selling in the futures context is generally viewed as a necessary and critical component of liquidity in the futures markets. Although the risk profile of short selling is similar in both the futures and securities contexts (price declines mean profitability for the short, while price increases mean unlimited potential losses), the SEC imposes extensive restrictions on the practice while the CFTC imposes few.

TREASURY BLUEPRINT, *supra* note 8, at 117. The Dutch banned the practice of short selling 300 years ago, and it was attacked by Napoleon.VII, LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3197–98 (3d ed. 2003). Ironically, Germany passed a statute in 1896 that prohibited futures trading because of concern that short selling was depressing agricultural prices. *Id.* at 3198; *see also* William P. Rogers & Jerry W. Markham, *The Application of West German Statutes to United States Commodity Futures Contracts: An Unnecessary Clash of Policies*, 19 L. & POL'Y IN INT'L BUS. 273 (1987) (discussing effects of that statute on American firms). That statute was not repealed until the end of the last century. Its repeal then allowed a German exchange, Eurex, to become the largest futures exchange in the world, wresting that title from the Chicago exchanges, until their recent merger. Peter A. McKay, *The Futures Are Now, As Eurex Is Cleared For Trading in U.S.*, WALL ST. J., Feb. 5, 2004, at C6.

317. The SEC defines a short sale as:

> A short sale is the sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. In order to deliver the security to the purchaser, the short seller will borrow the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by purchasing equivalent securities on the open market, or by using an equivalent security it already owned, and returning the security to the lender. In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security.

Short Sales, 69 Fed. Reg. 48,008 (Aug. 6, 2004).

318. 17 C.F.R. § 240.10a-1 (2009).

319. Short Sales, 69 Fed. Reg. at 48,008.

Critics also charged that short sellers had undermined Fannie Mae, Freddie Mac, and AIG.[320]

As these complaints mounted, the SEC began attacking "naked shorts" in the press. These were short traders who sold without having located the securities to borrow.[321] As the crisis worsened in September 2008, the SEC curbed naked short selling in the stock of Fannie Mae and Freddie Mac, as well as seventeen financial services firms, including Lehman Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley.[322] The SEC temporarily banned short selling in 799 financial stocks on September 19, 2008, after Lehman Brothers failed.[323]

SEC Chair Cox later said he regretted banning short selling and that he did so only after intense pressure from Treasury Secretary Henry Paulson and Federal Reserve Board Chairman Ben Bernanke. Cox's complaint further undermined the SEC's credibility, and raised questions about the SEC's independence and strength—especially because traders claimed that those restrictions had only further destabilized the market.[324] Whether that is true, the SEC's ban on short selling threatens derivative traders who sell short to hedge, and routinely speculate as a part of their business. Mary Schapiro, the new SEC chair, has suggested she might turn back the clock and reinstate the SEC's old up-tick rule. Though Federal Reserve Board Chairman Ben Bernake supported her in that effort,[325] it has not been met with universal approval.[326]

C. Single Stock Futures

The derivative market has more reason to resist a merger between the SEC and CFTC since the advent of single stock futures. Chicago is the leading single stock futures exchange in the United States. It was created through a joint venture of the CBOE, CBOT, and CME.[327] It

320. Vikas Bajaj et al., *Markets Soar, But New Rules Upset Traders*, N.Y. TIMES, Sept. 20, 2008, at A1.

321. Jenny Anderson, *Shares Revive Amid Confusing Signs From S.E.C.*, N.Y. TIMES, July 17, 2008, at C1.

322. *S.E.C. Extends Short-Sale Limits*, N.Y. TIMES, July 30, 2008, at C5.

323. Vikas Bajaj & Graham Bowley, *S.E.C. Temporarily Blocks Short Sales of Financial Stocks*, N.Y. TIMES, Sept. 20, 2008, http://www.nytimes.com/2008/09/20/business/20sec.html.

324. *Traders Group Faults SEC Over Decision on Short Selling Ban*, 41 Sec. Reg. & L. Rep. (BNA) 85 (Jan. 19, 2009).

325. *Bernanke Repeats Opposition to Outright Nationalization of Banks*, 41 Sec. Reg. & L. Rep. (BNA) 341, 342 (Mar. 2, 2009).

326. *SEC's Depression-Era Uptick Rule Said Irrelevant to Modern Marketplace*, 41 Sec. reg. & L. Rep. (BNA) 413 (Mar. 9, 2009)

327. OneChicago, Exchange Introduction, http://www.onechicago.com/?page_id=114.

should have been a sterling example of convergence between the two industries, but it has remained relatively minor because the SEC has insisted on its own brand of regulation for trading these new instruments. Most futures contracts have initial margins of less than 5% of the notional amount of the contract. The SEC, however, mandated a margin of 20% for single stock futures. This discouraged trading in single stock futures in the United States, and as a result, South Africa now hosts the largest single stock futures exchange.[328] This experience raises concerns that if the SEC and CFTC are combined the SEC will renew its assault on exchange-set margins on all commodities futures and other derivative instruments. This would discourage speculation, to the detriment of price discovery and hedgers.[329]

Single stock futures are another example of how overbearing SEC regulation can be in practice. Not only did the SEC insist on a suitability requirement for single stock futures,[330] it also imposed a prospectus-like requirement. As one author observed:

> The CFTC had mandated a single page risk disclosure document for futures contracts it regulates as a substitute for the "suitability" doctrine imposed by the SEC. However, the SEC concluded that traders in single stock futures needed both the protection of a suitability requirements and additional disclosures. Perhaps, the SEC thought that traders of such products are particularly stupid people. The result was a twenty-six page disclosure statement, rather than the single page disclosure form used for all other futures contracts.[331]

VIII. OTHER OBSTACLES TO MERGER

A. Jurisdiction of Congressional Committees

Historical and political factors also make a merger between the SEC and CFTC difficult, if not impossible. Perhaps the largest obstacle is that the banking committees in Congress oversee the SEC, while the agricultural committees oversee the CFTC. The agricultural committees will be reluctant to cede jurisdiction to the banking committees, even though that jurisdictional divide is the result of a historical accident. The agricultural committees focused on the commodity exchanges when regulation was first considered because their operations directly affected

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328. Lawrence Hunt Jr., *The Paulson Report is a Non-Starter*, 67 FINANCIER WORLDWIDE 53 (July 2008).

329. *Id.*

330. MARKHAM & HAZEN, *supra* note 38, at § 10:17.

331. Hunt, *supra* note 328, at 53.

the prices of crops.

Congressional banking committees had no interest in the commodity futures exchanges in the 1930s when the regulatory system was established because those exchanges only traded agricultural products.[332] That situation has changed dramatically as financial instruments came to dominate the derivatives markets. That change did not diminish the agricultural committees' interest. Those committees are under the sway of the Chicago exchanges and will not willingly cede their jurisdiction to the banking committees.

Soundings from the agriculture committees after the Obama Administration took office also evidenced no interest in giving up their jurisdiction to the banking committees. To the contrary, they seem bent on retaining that jurisdiction.[333] Collin Peterson, Chairman of the House Agriculture Committee, said that the SEC had "done a poor job" of regulating and that "[t]aking something that is working—like the CFTC's oversight of the futures markets—and moving it to another place where things are not working is, frankly, crazy."[334] Indeed, skirmishes over the role of the CFTC began early in 2009, after the House Agriculture Committee voted to give the CFTC expanded authority over derivatives. Barney Frank, Chairman of the House Financial Services Committee, opposed that bill. He wanted to limit the Agriculture Committee's jurisdiction to instruments involving "edible" commodities, leaving his Financial Services Committee to regulate everything else.

The Agriculture Committee, not surprisingly, rejected that proposal.[335] Frank then decided to place the SEC–CFTC merger aside, declaring that he was putting systemic-risk regulation as his top priority.[336] He had initially deferred consideration of a merger to the

332. The distinctive nature of the two markets before the advent of financial derivatives is illustrated by the Commodity Exchange Authority's advice to Congress in 1946. That bureau stated that it saw no reason to coordinate its activities with those of the SEC because most of the firms that it regulated were partnerships, rather than public corporations that the SEC regulated. The Commodity Exchange Authority also noted that there was a provision in the CEA that prohibited it from disclosing to the SEC the names of any traders who might be involved in any activity that might be in violation of the federal securities laws. The Commodity Exchange Authority asserted that, in any event, it had witnessed no such activity. MARKHAM, *supra* note 150, at 39–40.

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

334. *Peterson Says CFTC Only Regulator Suited to Oversee Mandated OTC Clearing*, 41 Sec. Reg. & L. Rep. (CCH) 230, 231 (Feb. 9, 2009).

335. Kara Scannell, *Derivatives Oversight Spurs House Turf Battle*, WALL ST. J., Feb. 13, 2009, at A4.

336. *Frank Puts Systemic Risk Regulation at Top of Financial Regulatory Reform Goals*, 41 Sec. Reg. & L. Rep. (BNA) 206 (Feb. 9, 2009).

second half of 2009, but he took it off the agenda entirely in March of that year.[337] Senate Banking Committee Chairman Christopher Dodd agreed with that priority.[338]

President Obama announced in February 2009 that he was seeking expedited action from Congress on regulatory reform, which would include, among other things, "more-uniform supervision of financial products."[339] The President outlined seven principles for designing a new financial regulatory structure, including uniform regulation of financial products that would prevent "cherry picking among competing regulators."[340] That the Administration vastly increased the budget of the CFTC for fiscal years 2009 and 2010, though, suggested a view toward permanency.[341] The Administration also announced in preparation for the Group of 20 meeting in London in March 2009 that it would focus on enhancing the powers of the Federal Reserve Board for addressing systemic risk concerns from large financial institutions. This seemed to signal that a SEC–CFTC merger would have to await those complex reform proposals, which will likely include higher capital requirements and perhaps even regulation of large hedge funds—all of which will undoubtedly be hotly contested.[342]

In May 2009, word began to leak that the Obama administration was focusing on creating a single bank regulator and a single investor protector regulator. But SEC Chair Schapiro opposed removing the SEC's consumer protection mission to another agency, so the SEC was exempted from that proposal.[343] It was also reported that, while the Obama Administration supported a merger of the CFTC and SEC, it was not prepared to take on a fight between the banking and agriculture committees.[344] Still another report stated that the SEC and CFTC chairs

337. *Groups Favor Systemic Risk Oversight; Frank Schedules Several Related Hearings*, 41 Sec. Reg. & L. Rep. (BNA) 393 (Mar. 9, 2009).

338. *Systemic Risk Should Be Initial Focus in Bid for Regulatory Reform, Dodd Says*, 41 Sec. Reg. & L. Rep. (BNA) 201 (Feb. 9, 2009).

339. Gregg Hitt, *Next Front: Bank Regulation*, WALL ST. J., Feb. 26, 2009, at A2.

340. *Obama Lists Key Principles for Reform of Nation's Financial Regulatory System*, 41 Sec. Reg. & L. Rep. 335 (Mar. 2, 2009). The other principles were "serious oversight" of large institutions posing systemic risk; reform of the present regulatory structure; transparency; accountability; comprehensiveness; and recognition of the global nature of financial services. *Id.*

341. *Obama Signs '09 Funding Bill for SEC, CFTC; Latter Agency Gets Dramatic Increase*, 41 Sec. Reg. & L. Rep. (BNA) 448 (Mar. 16, 2009).

342. Damian Paletta, *U.S. to Toughen Finance Rules*, WALL ST. J., Mar. 16, 2009, at A1.

343. Jim Kuhnhenn, *Fed Would Serve as Risk Regulator Under Obama Plan*, ASSOCIATED PRESS, May 27, 2009.

344. Damian Paletta, *Single-Regulator Plan For Banks Now Close*, WALL ST. J., May 28, 2009, at A2; Damian Paletta & Kara Scannell, *Financial Overhaul Raises Questions*, WALL ST. J., May 29, 2009, at A2.

had reached an agreement in May 2009 to divide their jurisdiction. They agreed to give the SEC control over derivatives related to publicly traded securities and credit default swaps, leaving the CFTC with jurisdiction over derivatives related to other products. The agreement, however, raised more questions than it answered.[345] For example, did it mean that the SEC would assume jurisdiction over futures on indexes traded on exchanges, or did the agreement apply to OTC derivatives only?

B. Industry Opposition

Opposition to merging the SEC and CFTC from the derivatives industry must also be considered. Proposals to merge the SEC and CFTC have surfaced over the years and each time the futures industry beat them back. Favorable and unfavorable views on the merger from industry participants were, at least initially, split by market, with the securities industry generally favoring merger and commodity markets opposing.[346] The force of the commodity market's opposition should not be underestimated. The CME, which now controls virtually all regulated futures trading in the United States after merging with the CBOT and the NYMEX, has effectively captured its regulator, the CFTC. It will not willingly relinquish that control to a more independent SEC-style regulator. The CME also exerts strong influence over the agriculture committees in Congress, and the majority whip, Senator Dick Durbin, hails from Chicago, as does President Obama. Consequently, the CME will have a decisive voice in the debate over

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345. Stephen Labaton, *An Overhaul of Financial Rules is Taking Shape*, N.Y. TIMES, June 1, 2009, at B1.

346. One commentator noted:

> CME Group, the National Futures Association, NYSE Euronext, the New York Mercantile Exchange, the Futures Industry Association, the Managed Funds Association, and two individual commentators favored the current system of separate regulators for the futures and securities markets. The Securities Industry and Financial Markets Association, Penson GHCO, Deutsche Bank, the Institute of International Bankers, the CFA Institute Centre for Financial Market Integrity, the Options Clearing Corporation, Deutsche Borse AG, and two individual commentators favored combining the CFTC and the SEC. The London Investment Banking Association, the International Swaps and Derivatives Association, the American Bankers Association and American Community Bankers, the International Council of Securities Associations, and the Financial Services Roundtable did not take a position on the merger, but argued that the United States should adopt a principles based regulatory regime. The North American Securities Administrators Association opined that a principles based regime would not improve the United States' financial markets.

Jerrold E. Salzman & Fitzgerald T. Bramwell, *SEC/CFTC Merger Is It Still the Same Debate*, 28 Fut. & Derv. L. Rep. 11 (Jan. 2008).

merger.

In 1992, the CME proposed consolidated regulation of all financial services in a department-level body.[347] That proposal would have subjected all financial services to the same level of regulation. It would have allowed financial service firms to compete on the products and services they offer, instead of the costs and limitations they incur dealing with their various regulators. That proposal, however, was a nonstarter because it would have eliminated the SEC's independence and placed regulation in a department under the President, subject to political influence.

The CME has become less flexible over the years. It has already opposed the Treasury Blueprint's merger recommendation.[348] In a letter to the Treasury Department, the CME stated:

> Differences among various financial markets will remain, despite any apparent convergence of some financial products. For example, the futures market is for the most part, a professional market, with institutional and commercial participants, and relatively few retail investors. This is in contrast to the nature of the participants in the securities, banking and insurance markets. Futures products are highly

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347. Hunt, *supra* note 328. As one author notes:

> The CME's proposal was first partially unveiled by Jack Sandner, the CME's chairman, in October 1992, who offered as its principal justification that the current regulatory system "leads to pure gridlock in trying to deliver products to the user." The CME's proposal would consolidate in a single, cabinet-level department a host of existing agencies in addition to the SEC and the CFTC: the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), the Securities Investor Protection Corporation (SIPC), the Pension Benefit Guaranty Corporation (PBGC), and certain functions of the Federal Reserve Board and the Department of Labor. In its own words, the proposal seeks, above all, a level playing field--namely, a functional system of regulation "so that financial products, services and markets delivering similar benefits and risks can be subjected to substantially equivalent regulation and so that economic competition, rather than jurisdictional barriers or differences in supervision, can determine which products, services and markets succeed in the marketplace." The new agency would be known as the Federal Financial Regulatory Service (FFRS or Agency) and would be administered by a board of nine commissioners, each appointed by the President and confirmed by the Senate, with the chairperson having cabinet-level rank. The Agency would, however, be radically decentralized with each of the nine commissioners being individually responsible for administration of a specified operating division of the FFRS. In this sense, the FFRS is less a single agency than a financial cabinet within which largely autonomous agency heads would collectively make financial policy. In short, this proposal's real goal (which is in no way disguised) is less merger of units than coordination of financial regulatory policies.

John C. Coffee, Jr., *Competition versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 451–52 (1995) (footnotes omitted).

348. *See* Letter from Craig Donohue, CEO, CME Group, Inc to the Treasury Dep't (Nov. 21, 2007) (on file with author).

> leveraged and are likely to be more complex than many products in other types of financial markets. The methods of trade execution and clearing differ among the futures, securities and banking industries, and have no relevance to the insurance market.
>
> Accordingly, these separate markets should continue to be regulated by separate agencies. A merger of the CFTC and the SEC would stifle innovation and competition in the futures industry, and would not benefit either industry with respect to the goals articulated by the Treasury Department. Putting the regulators of these very different markets under one roof would only create a larger, more inefficient bureaucracy, and would not enhance global market competition.[349]

The CME also criticized the SEC's regulatory approach, citing its restrictions on the CBOE over the years as an example of how regulation can stifle innovation.[350] The CME did urge the Treasury Department to push the SEC toward the principles-based regulation approach used by the CFTC.[351] The Treasury Blueprint adopted that recommendation.[352]

C. Advocates for Merger

There are advocates of merging the SEC and CFTC. Significantly, the Obama Administration has repeatedly supported such a merger.[353] But the Administration's support is not guaranteed because the President hails from Chicago and will be strongly lobbied by that city to protect the CME, one of its most important industries. The Financial Services Roundtable, composed of the larger financial services firms, has also voiced support for a merger.[354] The Investment Company Institute (ICI), one of Washington's more powerful lobbying groups has supported a proposal to create a new Capital Markets Regulator that would take over the SEC's and CFTC's functions. The ICI asserted that such a regulator would provide a "big picture" oversight of financial products.[355]

Before leaving office, SEC Christopher Chairman Cox had announced his support of a merger with the CFTC.[356] The acting

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349. *Id.* at 3.

350. *Id.* at 8.

351. *Id.* at 10–11.

352. TREASURY BLUEPRINT, *supra* note 8, at 106–11.

353. *Frank Puts Systemic Risk Regulation at Top of Financial Regulatory Reform Goals*, *supra* note 336.

354. *Financial Services Roundtable Says Fed Should Oversee Stability of Financial System*, 41 Sec. Reg. & L. Rep. (BNA) 202 (Feb. 9, 2009).

355. *ICI Issues Reform Proposal Calling for Risk, Capital Market Regulators*, 41 Sec. Reg. & L. Rep. (BNA) 396 (Mar. 9, 2009).

356. Dwight Cass, *Projecting Calm Amid the Chaos*, N.Y. TIMES, Oct. 27, 2008, at B2.

Chairman of the CFTC stated a few weeks later that both the CFTC and the SEC should be abolished and replaced by three new regulatory bodies that would focus on risk, market integrity, and investor protection.[357] Later, SEC Commissioner Luis Aguilar complicated the process by urging Congress to give the SEC jurisdiction over all financial products. Aguilar said that any merger with the CFTC should be conditioned on applying SEC-style regulation.[358] Gary Gensler, the Obama Administration's pick for the CFTC Chair was equivocal in his confirmation proceedings about a merger, probably in deference to the agriculture committees and CME. Gensler said that "[a] merger . . . makes sense only if it enhances our ability to carry out the important tasks with which the CFTC is entrusted."[359]

Mary Schapiro, the new SEC Chair, who previously served both as a CFTC Chair and SEC Commissioner, brings a new dynamic to the equation. With her experience, Schapiro appears to be an ideal fulcrum for combining the two agencies. Schapiro has been quoted as saying that financial services regulation was a "spaghetti bowl" of regulators, and questioned the sense of two regulatory agencies.[360] Nevertheless, she too has cautioned against a "monolithic regulator"[361] and has advocated preserving the present SEC regulatory structure, which would be a threat to the commodity industry if a merger occurs.[362] Schapiro has also promised a return to the heavy-handed enforcement tactics of prior SEC administrations. She even wants to re-impose regulating hedge funds and further regulate rating agencies.[363]

D. Principles-Based Regulation

Merging the SEC's and CFTC's cultures will pose serious problems to developing a consistent regulatory approach.[364] The Treasury

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

358. *Aguilar Urges Functional Regulation; Merged Agencies Should Favor SEC Model*, 41 Sec. Reg. & L. Rep. (BNA) 156 (Feb. 2, 2009).

359. *Gensler Says Chief Goal as CFTC Chairman Would be Reforming Financial Regulations*, 41 Sec. Reg. & L. Rep. (BNA) 230 (Feb. 9, 2009).

360. Brodsky, *supra* note 287.

361. *Witnesses Testify to Regulatory Gaps; Schapiro Warns of 'Monolithic' Regulator*, 41 Sec. Reg. & L. Rep. (BNA) 549 (Mar. 30, 2009).

362. *Schapiro Vows to 'Reinvigorate' Enforcement at SEC if Confirmed*, 41 Sec. Reg. & L. Rep. (BNA) 77 (Jan. 19, 2009).

363. Labaton, *supra* note 294, at A1. Two sector working groups created by the Presidential Working Group issued reports in January 2009 that sought to head off regulation of the hedge funds by advocating a "best practices" approach. *President's Working Group Panels Issue Best Practices for Hedge Fund Investing*, 41 Sec. Reg. & L. Rep. (BNA) 107 (Jan. 26, 2009).

364. For a description of such harmonization see Carlucci, *supra* note 195.

Blueprint recognized that concern and sought to alleviate it by advocating that the SEC convert to a principles-based regulatory system, like the CFTC.[365] The Blueprint also faults the SEC's delays in approving rule changes by stock exchanges. A constant criticism of the SEC is that delays in approvals needed for new products stifles innovation and competition. In that regard, the Blueprint recognized that the CFTC allows exchanges to self-certify that their rule changes comply with regulatory requirements and places the burden on the CFTC to hold otherwise.[366] This too was an effort to make a merger more palatable to the futures industry.

Those recommendations, even if implemented, are probably not enough to obtain the futures industry's support for a merger. There remains concern that the SEC will superimpose any principles-based regulation it adopts over its existing overly intrusive rules-based structure. This will mean an additional layer of regulation, not less regulation. In addition, any SEC principles will likely be couched in broad terms. This will allow the SEC to invent the law ad hoc, and charge that any conduct it does not like violates its principles and push traders to offshore financial services.

In February 2009, the U.S. Chamber of Commerce weighed in with a proposal that argued attention to the SEC's enforcement failures overlooked other problems at that agency. The Chamber suggested revamping the SEC's management structure and hiring personnel knowledgeable about the financial services regulated by the SEC. Like the Blueprint,[367] the Chamber advocated a more streamlined decision making processes for no-action letters, exchange rule approvals, and exemptions from the Investment Company Act of 1940.[368]

The markets historically regulated by the SEC and CFTC are effectively extinct; electronic trading is replacing the trading floors of the NYSE and the Chicago commodity futures. This eliminates the agencies' concerns with how to regulate floor traders with a time and place advantage that they can use to exploit investors.[369] Also concerning was the widespread failure of risk models used under Basel II by the banks, consolidated supervised entities once supervised by the SEC and by the rating agencies.

365. TREASURY BLUEPRINT, *supra* note 8, at 111.

366. *Id.* at 111–12.

367. TREASURY BLUEPRINT, *supra* note 8, at 111–13.

368. *Chamber of Commerce Recommends Changes Toward More Effective SEC*, 41 Sec. Reg. & L. Rep. (BNA) 294 (Feb. 23. 2009).

369. *See generally* Markham & Harty, *supra* note 256 (describing this phenomena).

E. Practical Concerns

The Treasury Blueprint also noted practical distinctions between the SEC and CFTC. For example, the SEC is largely funded through fee collection from market participants and congressional appropriations; the CFTC is funded entirely by congressional appropriation.[370] This is because an effort to impose "user fees" to fund the CFTC was beaten back by the industry in 1982. The industry thought it was bad enough that it was saddled with the CFTC and did not want to pay for it too.[371] The CFTC again proposed user fees in 2008, claiming that the industry was benefiting from regulation and should pay for it. Doubtless the industry disagrees, and this proposal has not advanced.[372]

It is also unclear whether a merger will significantly reduce costs to taxpayers. Because the CFTC's operating staff is already overstretched, any savings in redundancies would be through cuts in the "Executive Direction & Support" part of the budget; this was about 26% ($30 million) of the CFTC's proposed $116 million budget for 2008. Even a 50% reduction in staff from redundancies with SEC administrators would save only a little more than $17 million.[373] Initially offsetting even those meager savings would be costs incurred in merging the two agencies' headquarters and branch offices. There would be other expensive integration costs.[374] The GAO suggested in 1995 that there could be enforcement advantages from a merger, but conceded that there would still be a need for specialized attorneys and investigators for each market.[375]

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370. TREASURY BLUEPRINT, *supra* note 8, at 118.

371. Don L. Horwitz & Jerry W. Markham, *"Sunset" on the Commodity Futures Trading Commission: Scene II*, 39 BUS. LAW. 67, 80–81 (1983).

372. *Commodity Futures Trading Commission's Ability to Regulate Markets is on Trial*, AGWEEK, July 15, 2008.

373. COMMODITY FUTURES TRADING COMM'N, FY 2008 PRESIDENT'S BUDGET AND PERFORMANCE PLAN 43 (2008), *available at* http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/2008budgetperf.pdf.

374. For a description of the difficulties that a merger of the two agencies may encounter see Paul M. Architzel & Jason E. Wynn, *Blueprint for Reform: Is a Choice-of-Regulator MOU A Better Interim Solution?*, 28 Fut. & Derv. L. Rep. 1 (June 2008).

375. The GAO stated:

> Merging CFTC and SEC could yield a number of potential enforcement benefits such as: enhanced inter-market surveillance and enforcement activities, increased opportunities for training, additional resources to pursue futures related violations, and elimination of ambiguity about which agency has enforcement responsibility over derivative products. However, regardless of whether the agencies are merged or not, there would still be the need for attorneys and investigators with some specialized skills and expertise in futures and securities laws and markets.

U.S. GEN. ACCOUNTING OFFICE, CFTC/SEC ENFORCEMENT PROGRAMS: STATUS AND POTENTIAL

IX. REFORMING REGULATORY POLICY

A. Political Considerations

More than the existing haphazard, ineffective, and punitive regulatory approaches taken by the SEC and CFTC is needed. The Treasury Blueprint recommends an objectives-approach instead of functional regulation. It also seeks to reorganize financial services regulation to reflect that financial services are no longer sold through firms that specialize in only one product, such as banking, securities, or derivatives. It is unclear, however, how merging the SEC and CFTC would provide better regulatory protection, without consolidating all financial services business practices regulation into a single body.

Regulatory reform should focus on more efficient and effective regulation, rather than compromises to satisfy the SEC and CFTC. Yet the problems encountered in the financial markets during the subprime crisis place almost irresistible pressure to impose more inefficient regulations. Political considerations can never be avoided—and should not. But in this crisis rationality should be the driving criteria for regulatory reform. This requires an examination of the core causes of the subprime crisis, most of which have little or no relation to the missions of either the SEC or CFTC.

B. Defects in Policy

The subprime crisis was largely caused by the Federal Reserve Board's interest rate policies, which fed the residential real estate bubble. The Federal Reserve Board under Alan Greenspan tried to use interest rates to regulate the overall economy. This began with low interest rates after a near-recession in the early 1990s. The availability of easy money set off a stock market bubble that Greenspan initially ignored, but he then became alarmed as it grew in intensity. Greenspan tried to deflate the bubble by demonizing it ("irrational exuberance") and increasing interest rates until the market broke and the economy was crippled.[376] This event is known as the dot.com bust that occurred at the

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IMPACT OF A MERGER 1 (1995).

376. This mode of attack was approved by John Maynard Keynes, an English economist who stated that: "The proper object of dear money is to check an incipient boom." LIAQUAT AHAMED, LORDS OF FINANCE: THE BANKERS WHO BROKE THE WORLD 237 (2009). Interestingly, Keynesian views on using government spending to stimulate the economy in a downturn had been viewed to be outmoded in the Greenspan era, a view that changed dramatically during the subprime crisis with the adoption of a $787 billion stimulus package. Daniel Henninger, *Earmark Nation*, WALL ST. J., May 14, 2009, at A15.

end of the 1990s.

The bubble burst in 2000, hammering the economy and leaving the new President George W. Bush with a nasty economic situation.[377] The Fed then desperately slashed interest rates to restore the economy, but that set off another bubble, i.e., the residential real estate bubble that led to the current crisis. The process then repeated; the Fed raised interest rates until that bubble burst. In fact, the Fed raised interest rates seventeen consecutive times. That not only broke the back of the residential real estate market, but smashed the economy, nearly forcing it into a depression not seen since the 1930s. The Fed is now repeating this cycle by cutting interest rates to near zero.[378] It should abandon this strategy or adopt something more predictable and rational, such as a targeted rate adjusted only for inflation.[379]

Government policies contributed to other core causes of the subprime crisis. For example, government policies pushed the investment banks into the subprime market and legitimized the risks of such instruments and flawed fair value accounting requirements. The SEC must accept some responsibility for these actions, which caused financial institutions to value subprime-related assets at fire sale prices, thereby undermining their financial stability and causing a loss of confidence in the market.[380] The present regulatory policies also failed during the subprime crisis. Current regulatory policy demands punitive and poorly reasoned legislation as a reaction to the burst market bubble and its exposure of abusive practices such as Enron and WorldCom. SOX is the prime example for why this approach has the inevitable result of punishing the innocent, imposing unnecessary burdens and costs on legitimate business, and impairing U.S. businesses' ability to compete abroad, without corresponding benefits.[381]

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377. I have described those events in MARKHAM, *supra* note 58.

378. E.S. Browning, *Too Much Hope May be Pinned on Rate Cut*, WALL ST. J., Sept. 17, 2007, at A1. Alan Greenspan and Ben Bernanke must bear equal responsibility for destroying the economy with these interest rate increases. Many market participants thought that when Bernanke took office it would be "one and done," meaning that he would raise interest rates one more time before stopping. HARRIS, *supra* note 240, at 32. However, that did not prove to be the case. Bernanke raised rates three more times and paused for over a year between June 2006 and September 2007 before making a series of rate cuts through December 2008 that gradually brought rates to near zero. *See* Fed. Reserv Bd., FRB: Monetary Policy, Open Market Operations, http://www.federalreserve.gov/fomc/fundsrate.htm.

379. Jerry W. Markham, *Give Paulson a Chance*, EXECUTIVE VIEW, July 1, 2008, http://www.executiveview.com/knowledge_centre.php?id=2100 (describing this phenomena).

380. I have addressed these shortcomings in Jerry W. Markham, *The Subprime Crisis—Some Thoughts on a "Sustainable" and "Organic" Regulatory System*, 4 F.I.U. L. REV. 381 (2009). FASB did give some relief on fair value accounting in April 2009. Francesco Guerrera, et al., *Accounting Windfall for Banks*, FIN. TIMES (London), April 2, 2009, at 15.

381. *See supra* notes 12–21 and accompanying text.

SOX cost American businesses billions of dollars without any measurable positive result. It was punitive, costly legislation that was intended to stop accounting manipulations at public companies where restatements had become epidemic.[382] Tellingly, despite its crippling competitive effect, SOX did not diminish the number of accounting restatements.[383] Indeed, a record number of restatements took place in 2006.[384] Additionally, despite claims that registration of hedge funds would prevent and detect fraud, Bernie Madoff's registration had no such effect. Rather he carried out the largest investment fraud in history right under the SEC's nose.

The federal government also regulated the ratings agencies after the Enron-era scandals as punishment for not downgrading Enron until just before it failed.[385] That regulation did nothing to affect the rating agencies' faulty AAA ratings of subprime debt that gave such toxic instruments broad market acceptance. The rating agencies downgraded thousands of issues of subprime mortgage securitizations that they had previously given high ratings. For example, in July 2007, Moody's cut ratings on CDOs valued at $5 billion. Between July and August 2008 alone, Moody's downgraded nearly 1,000 issues valued at $25 billion. By February 2009, there were 16,000 downgrades worldwide, over 90% of which were CDOs.[386]

Regulatory policy also includes high-profile prosecutions brought by the SEC, Justice Department, and ambitious New York attorneys general, such as Eliot Spitzer or Andrew Cuomo. Particularly in New York, prosecuting financial services executives is a means for ambitious prosecutors to gain fame and higher public office, e.g., Eliot Spitzer, Rudy Giuliani, and now Andrew Cuomo. Federal regulators also use prosecutions to deflect criticism of their failure to prevent or detect the misconduct or problems that lead to scandal or market panic. The worst scandals emerge in market downturns, which is called market discipline. This is more effective than after-the-fact prosecutions by ambitious prosecutors.

Those prosecutions inevitably involve showy press conferences, dawn

382. *See supra* note 121 and accompanying text.

383. SUSAN SCHOLZ, THE CHANGING NATURE AND CONSEQUENCES OF PUBLIC COMPANY FINANCIAL RESTATEMENTS (1997–2006) 1 (2008); *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, UPDATE OF PUBLIC COMPANY TRENDS, MARKET IMPACTS, AND REGULATORY ENFORCEMENT ACTIVITIES (2006) (describing causes of increasing restatements).

384. David Reilly, *Restatements Still Bedevil Firms*, WALL ST. J., Feb. 12, 2007, at C7.

385. Credit Rating Agency Reform Act of 2006, § 4, Pub. L. No. 109-291, 120 Stat. 1327 (codified at 15 U.S.C. § 78o-7 (2006)) required the rating agencies to register with the SEC and gave that agency rule making authority to govern their business practices.

386. Paul J. Davies, *Half of All CDOs of ABS Failed*, FIN. TIMES (London), Feb. 11, 2009, at 25.

raids on executive homes, and shackling executives for their "perp" walks. Because prosecutors' cases are often weak and difficult to prove, they try to coerce guilty pleas. For example, prosecutors often indict employees on multiple counts that will result in life imprisonment unless the employee pleads guilty to lesser charges and testifies against higher-ups. Prosecutors also indict family members to force a guilty plea from their executive relatives. No tactic is too low for prosecutors.[387] Companies were even required to waive their attorney-client privilege and limit attorney fees to avoid indictment and destruction. Only after a lecture from a federal judge did the Justice Department retreat from some of these tactics.[388]

Policymakers should consider what these prosecutions accomplish. They do not have a deterrence effect. Fraud and scandals continue in ever-increasing numbers. Yet following the subprime crisis the CFTC has petitioned Congress to grant it authority to bring criminal prosecutions.[389] If adopted other agencies would seek the same powers, which would lead to more highly publicized prosecutions and prosecutorial abuses, as the regulators vie for headlines.[390]

Class action lawyers feed on this prosecutorial frenzy, filing strike suits on behalf of union pension funds whenever a public company announces bad news. These lawsuits allow class action lawyers to garner a handsome profit and improve the pension funds' returns at the expense of other shareholders. They accomplish nothing else—except to distract management. The subprime crisis has all ready set off another round of class action lawsuits.

The Reserve Primary Fund, the money market fund that broke-the-buck in September 2008 because of exposure to Lehman Brothers' debt, is a good example of this system's abuses. The Reserve Primary Fund held $64 billion when it collapsed. Only $785 million of that amount was invested in Lehman notes. The Reserve Fund's biggest loss turned out to be a $3.5 billion reserve set up to cover the costs of regulatory actions and investor lawsuits. That reserve, if expended, would reduce investors' final recovery to 91.72 cents on the dollar.[391] Fortunately,

387. Markham, *supra* note 379.

388. *See* United States v. Stein, 541 F.3d 130 (2d Cir. 2008) (dismissing indictments); *see also* United States v. Stein, 440 F. Supp. 2d 315 (S.D.N.Y. 2006) (suppression of statements made by defendants because of coercion in the form threats of job termination).

389. Javier Blas & Joanna Chung, *CFTC Seeks Authority in Crime Cases*, FIN. TIMES (London), Feb. 27, 2009, at 5.

390. As predicted, an SEC commissioner was seeking such authority for the SEC in March 2009. *Aguilar Call for Enhanced SEC Enforcement, Including Authority to Bring Criminal Action*, 41 Sec. Reg. & L. Rep. (BNA) 492 (Mar. 23, 2009).

391. Diana B. Henriques, *Lehman Loss Just the Start for Money Fund*, N.Y. TIMES, Feb. 27, 2009,

common sense prevailed and that litigation was cut off by a federal judge, allowing a payout of most of the customers' funds, but only after a delay of over a year.[392]

X. CONCLUSION

Functional regulation is a failure. It is broken beyond repair and should be abandoned. The Enron-era scandals, subprime crisis, and Madoff scandal evidence its failure. Enron should have taught policymakers that punitive legislation and prosecutions are not rational responses to financial problems. A carefully reasoned approach to regulation is necessary. The Treasury Blueprint has made that effort. Many market participants will not agree with all of its recommendations, but it is at the least, a good starting point. More importantly, the Blueprint evidences that financial regulation can be objective and reasoned, rather than a blood sport for ambitious prosecutors and politicians.

The proposal to merge the CFTC and SEC appears reasonable on its face, particularly if the SEC can be persuaded to shift to principles-based regulation. But that merger would be unwise if the SEC continues its culture of discouraging speculation through high margin requirements and short sale restrictions. A merger would severely damage or drive away derivatives trading. The two agencies' cultural differences must also to be melded in areas such as insider trading and risk disclosures. It seems doubtful that the SEC would accede to such changes, and the agricultural committees in Congress are unlikely to cede jurisdiction absent such changes. So the status quo will most likely prevail.

The SEC and CFTC should become financial regulators instead of law enforcement agencies. The two agencies now act as legislature, prosecutor, judge, and jury in their administrative proceedings. This creates an unhealthy adversary relationship with the regulated. A financial regulator should make rules and leave enforcement of those rules to others. This recommendation conforms with ongoing efforts to create a single business practices regulator that would separate law enforcement and attack abuses across product lines.

The CME's 1992 proposal may have been correct, and that recommendation should be revisited: A Department of Finance would leave financial regulators to watch for problems, to make risk assessments, and to track industry changes and problems so that they can

at B9.

392. Daisy Maxey, *Judge's Order Splits Reserve Fund Investors*, WALL ST. J., Nov. 30, 2009, at C8.

be dealt with before becoming a crisis. Industry and government should develop risk models that account for the disasters that will inevitably occur. This does not mean abandoning risk-taking. This would be a mistake because society cannot advance without taking risks. Rather a Department of Finance would mean that risks will be better appreciated before capital is massively committed to a particular program. Financial regulation would also include examiners who would review the operations and financial status of systemically important financial institutions on an ongoing basis. Finally, restructuring financial regulation should consider the effects of government policy initiatives, whether it be encouraging subprime lending, or raising interest rates to stop speculation. Perhaps most importantly, policymakers should address the root causes of the subprime crisis before changing the existing regulatory structure.

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