SYMPOSIUM

DO FINANCIAL SUPERMARKETS NEED SUPER REGULATORS?

FOREWORD

Joan G. Wexler

Good Morning. I'm Dean Joan Wexler and I am delighted to welcome all of you to Brooklyn Law School for our conference that poses the question: "Do Financial Supermarkets Need Super Regulators?" I would especially like to thank the *Center for the Study of International Business Law*, and the *Brooklyn Journal of International Law* for sponsoring the conference, and those individuals at the law school who have made the conference possible, in particular, Professors Roberta Karmel and Jim Fanto, Michelle Scotto of the Office of Special Events and Jessica Lubarsky of the *Journal*.

It gives me great pleasure to welcome such a distinguished group of academics, and practitioners to our law school to study and discuss a topic that is an important issue in the law and policy of financial institutional regulation. Today we will consider what is the best model for financial regulation — the single regulator or functional regulation. This question has been raised because financial institutions no longer fit neatly into clear categories such as banks, insurance companies, and investment firms. Indeed, not only might a bank sell insurance products or underwrite securities, but one financial institution might have different divisions or subsidiaries that collectively perform all financial functions. The latter, of course, is the financial supermarket. This business development raises a key policy question: what is the appropriate kind of financial regulation in the new environment? Should one have a super regulator that oversees all kinds of financial businesses, or should a government maintain separate regulators for each kind of financial business, perhaps with enhanced cooperation among them? This inquiry is not just an academic one because some countries have already settled upon different approaches. For example, the United Kingdom has consolidated all financial regulation into a new, single government agency: the Financial

Services Authority. And other European countries have either also done so or are considering adopting such a model. With the passage of the Gramm-Leach-Bliley Act, the United States has chosen functional regulation — so that financial institutions can undertake a variety of financial services businesses and there remain, as you know, separate financial regulators. Today's theoretical discussion about what might we best do, what is the best approach, will thus be complimented by reflecting upon the preliminary experience and data that we already have regarding different models of regulation.

Over the years, our *Center for the Study of International Business Law* has sponsored conferences on current topics of international business. These conferences have produced lively debates here, and important scholarly contributions for our journals and I know that this morning's conference promises to continue that tradition. Once again, I welcome you and I want to let you get down to the work of the day.

EXAMINING THE UNITED KINGDOM'S EXPERIENCE IN ADOPTING THE SINGLE FINANCIAL REGULATOR MODEL

Eilís Ferran[*]

I. INTRODUCTION

In major markets around the world there has been a growing trend towards unification of responsibility for the regulation of banks, securities markets, and insurance companies.[1] Countries where a unified agency has recently assumed regulatory responsibilities for all financial institutions include the United Kingdom ("U.K."), Japan, and Korea.[2] In May 2002, Germany established a single financial regulator.[3] Ireland and Switzerland are also in the process of moving towards the single regulator model.[4] The increasing popularity of the single regulator model in Europe should be viewed against the background

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I am grateful for comments from Kern Alexander, Chris Bates, Rod Cantrill, James Fanto, Niamh Moloney, Tolek Petch, and participants at the Brooklyn Law School Symposium *Do Financial Supermarkets Need Super Regulators?,* September 20, 2002. This Article reflects the position as of September 2002, but with occasional references to more recent material.

1. Kenneth K. Mwenda & Alex Fleming, International Developments in the Organizational Structure of Financial Services Supervision, Paper Presented at the World Bank Financial Sector Vice-Presidency Seminar, at 1 (Sept. 20, 2001), *available at* http://lnweb18.worldbank.org.

2. NEIL COURTIS, HOW COUNTRIES SUPERVISE THEIR BANKS, INSURERS AND SECURITIES MARKETS xiii (2d ed. 2002). Although Courtis classifies Australia as a single regulator country, its approach is distinctive in that it divides between two agencies responsibility for prudential regulation (Australian Prudential Regulation Authority) and for conduct of business (Australian Securities and Investment Commission). The Netherlands is considering the adoption of a similar cross-sectoral, objective-driven model. *See* Annet Jonk et al., *A New Dutch Model,* 6 FIN. REG. 35 (2001).

3. Hugh Williamson, *Boost for Germany's Financial Role: Federal Agency Three Regulatory Bodies to be Merged into Single Authority from May 1*, FIN. TIMES, Apr. 3, 2002, at 12.

4. Howard Davies, *Foreword — The Importance of Getting Supervision Right*, *in* COURTIS, *supra* note 2, at xi.

of the policy objectives of the European Union ("EU") in the establishment of a fully integrated financial market. The convergence of national regulatory structures of member states has been identified as a necessary step for the achievement of that good.[5]

Scandinavian countries led the way in establishing unitary financial regulators.[6] Norway was the first country to establish an integrated regulatory agency in 1986, followed by Denmark in 1988, and Sweden in 1991.[7] However, as the first major international financial center to adopt the single regulator model,[8] changes made in the U.K. have attracted particular international attention. For countries that are major financial centers,[9] an important argument in favor of the single regulator model is that it matches the nature of their markets — in that the emergence of financial "supermarkets" and increased use of sophisticated techniques, such as securitization and derivatives trading, have broken down the traditional sectoral distinctions.[10] The trend towards the blurring of sectoral boundaries intensified during the 1990s.[11] The overhaul of the U.K.'s regulatory structure thus largely coincided with a period in which

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5. THE COMMITTEE OF WISE MEN, FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS 42 (2001), *available at* http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf.

6. Giorgio Di Giorgio & Carmine Di Noia, *Financial Market Regulation and Supervision: How Many Peaks for the Euro Area?,* 28 BROOK. J. INT'L L. 463, 469–78 (2002) (providing a general survey of European regulatory frameworks).

7. MICHAEL TAYLOR & ALEX FLEMING, INTEGRATED FINANCIAL SUPERVISION: LESSONS FROM NORTHERN EUROPEAN EXPERIENCE 4–7 (World Bank, Working Paper No. 2223, 1999), *available at* http://econ.worldbank.org/files/950_wps2223.pdf. Banking supervision has never been a central bank function in these countries so the Scandinavian experience has little guidance to offer on this aspect of regulatory consolidation.

8. CLIVE BRIAULT, THE RATIONALE FOR A SINGLE NATIONAL FINANCIAL SERVICES REGULATOR 5 (FSA, Occasional Paper 2, 1999), *available at* http://www.fsa.gov.uk/pubs/occpapers/index-1999.html [hereinafter BRIAULT, THE RATIONALE].

9. This argument may be less significant for countries with smaller or less mature markets. *See* RICHARD K. ABRAMS & MICHAEL W. TAYLOR, ISSUES IN THE UNIFICATION OF FINANCIAL SECTOR SUPERVISION 10–14 (International Monetary Fund, Working Paper No. 00/213, 2000), *available at* http://www.imt.org/external/pubs/ft/wp/2000/wp00213.pdf.

10. BRIAULT, THE RATIONALE, *supra* note 8, at 12–17.

11. *Id.* at 12–14.

the need for changes to national regulatory arrangements, in order to keep pace with the markets, was an issue for public policy debate in many countries.[12]

In addition to trends in the international financial markets, changes to national financial regulatory structures are also driven by country-specific factors.[13] This was certainly true in the U.K., where some of the impetus for change came from local financial scandals and collapses that were attributed, in part, to failings in the old system.[14] Throughout the world, there is wide variety in the existing institutional arrangements and, despite the current interest in the single regulator model, its adoption in practice remains relatively rare.[15] The powerful influence exerted by national historical roots and social, economic, and political traditions[16] means that this situation seems likely to persist. To take the obvious example of the United States, adoption of the single regulator model would face practical and political hurdles that currently appear insurmountable.[17] The recognition that national institutional arrangements evolve under the influence of local factors, as well as global trends in financial markets, suggests that there is no one ideal institutional model that is universally applicable.

While this Article makes no claim as to the superiority of the single regulator model, it considers what other countries may learn from the U.K.'s experience in adopting that structure. A key feature is the extent of fundamental legal change that accompanied the U.K.'s shift to the single regulator model. Unlike some other countries, such as Korea which has a single regulatory agency but separate sectorally-divided legal regimes,[18] the U.K. has sought to match the unitary nature of its

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12. CHARLES GOODHART ET AL., FINANCIAL REGULATION: WHY, HOW AND WHERE NOW? 181 (1998).

13. *Id.*

14. BRIAULT, THE RATIONALE, *supra* note 8, at 8.

15. ABRAMS & TAYLOR, *supra* note 9, at 3. But others see "clear signs" of a trend towards unified supervision, particularly for larger financial markets. *See, e.g.,* COURTIS, *supra* note 2, at xiii.

16. GOODHART ET AL., *supra* note 12, at 145.

17. According to Federal Reserve Chairman Alan Greenspan, the creation of a single regulator would be "highly undesirable on both political and economic grounds." ROSA MARIE LASTRA, CENTRAL BANKING AND BANKING REGULATION 147 (1996).

18. *See generally* Joon Soo Lee, Integrated Financial Supervision: The Korean Experience (Asian Development Bank Project, 2002) *available at*

institutional arrangements for financial regulation with an integrated legal framework. This ambitious approach means that the U.K. should be a particularly rich source of data on using the law to respond to the challenges involved in the process of regulatory consolidation. Part II of this Article sets out the historical background of the transition to the single financial regulator model in the U.K. Part III examines the key events in the transitional period between the announcement of the intended switch and the effectuation of the new unitary regime in December 2001. Part IV looks at the main arguments — for and against — the single regulator model; how the British legislature responded to these arguments in shaping the legislative framework for the new regime; and at early indications of how successfully that framework is beginning to operate in practice. Part V offers one conclusion and some observations.

II. THE BACKGROUND TO THE ADOPTION OF THE SINGLE REGULATOR MODEL IN THE U.K.

The 1980s were a period of regulatory upheaval in the U.K. At that time the U.K. had a fragmented regulatory structure, with different institutional arrangements and legal regimes in place for banking, securities, and insurance business. This historical survey examines key events in the period up to May 1997, when a new Labour government was elected in place of the Conservative government that had been in power since 1979.

In the days immediately following the 1997 election, the new Labour government moved with remarkable swiftness to start the process of switching to the single regulator model. This was one of the new government's first major policy initiatives.[19] This begs the question: What had happened to put regulatory reform so high on the new government's list of priorities?

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www.adb/org/projects/APEC/market_intermediaries/integrated_financial_supervision_kor.pdf.

19. Eva Lomnicka, *Reforming U.K. Financial Services Regulation: The Creation of a Single Regulator*, 1999 J. BUS. L. 480.

A. Banking Regulation[20]

In the 1980s, regulatory responsibility for the U.K. banking sector lay with the central bank — the Bank of England ("the Bank"). Although the Bank's informal involvement in the supervision of banks dates back to the mid-nineteenth century, it was only in 1979 that it acquired formal powers to grant or refuse authorization to carry on a banking business in the U.K.[21] Catalysts for the changes made by the Banking Act 1979 were the secondary banking crisis of 1973–1974 and the Banking Coordination Directive of 1977, which was the first major step towards European harmonization in the banking sector.[22]

Banking failures continued to influence change throughout the following years. In 1984, the collapse of Johnson Matthey Bankers Ltd. exposed defects in the framework established by the Banking Act 1979.[23] As a consequence, that structure was replaced by a new legislative framework.[24] The Banking Act 1987 confirmed the Bank in its role as bank regulator and strengthened its supervisory powers.[25] The 1987 Act introduced a new "Board of Banking Supervision" to assist the Bank in its supervisory functions.[26]

In 1991 another bank failure —the Bank of Credit and Commerce International ("BCCI") — again put the U.K. banking regulatory framework under scrutiny.[27] Although international supervisory action coordinated by the Bank had brought about BCCI's closure in 1991, the Bank was heavily criticized for not intervening sooner to stop BCCI's fraudulent operations.[28] An

20. This section draws upon chapter 1 of the INQUIRY INTO THE SUPERVISION OF THE BANK OF CREDIT AND COMMERCE INTERNATIONAL (HM Stationary Office, 1992) [hereinafter BINGHAM REPORT], which provides an excellent overview of banking supervision in the U.K. in the period 1972–1992.

21. Banking Act, 1979 (Eng.) (repealed 1987).

22. BINGHAM REPORT, *supra* note 20, ¶ 1.15.

23. *Id.* ¶ 1.38.

24. Banking Act, 1987 (Eng.) (repealed 2001).

25. BINGHAM REPORT, *supra* note 20, ¶ 1.47.

26. *Id.*

27. *See generally* Ray P. Kinsella, *Some Regulatory and Supervisory Lessons of the BCCI Collapse, in* INSTITUTE OF EUROPEAN FINANCE, RESEARCH PAPER NO. 92/10, RESEARCH PAPERS IN BANKING AND FINANCE (1992); PETER TRUELL & LARRY GURWIN, FALSE PROFITS: THE INSIDE STORY OF BCCI, THE WORLD'S MOST CORRUPT FINANCIAL EMPIRE (1992).

28. *See generally* Kinsella, *supra* note 27.

official inquiry, chaired by Lord Justice Bingham, was convened. The inquiry found weaknesses in the Bank's approach to coping with sophisticated fraud. Specifically, it was found that the Bank relied too heavily on informal methods based on trust and frankness.[29] It also identified gaps in the Bank's powers. In response, certain technical changes were made to the Banking Act 1987, as well as changes to the Bank's supervisory practices.[30] On the more radical question — whether a reorganization of regulatory responsibility was required — the inquiry produced a negative response.[31] The option of transferring banking regulatory responsibility from the central bank to an independent body was specifically rejected.[32] The inquiry found nothing in the history of BCCI to invalidate the judgment, made prior to the Banking Act 1987, to continue to entrust this task to the Bank.[33]

The spectacular collapse of Barings in 1995 prompted another official inquiry in the U.K., this time by the Board of Banking Supervision.[34] The Barings crisis had been triggered by massive unauthorized losses incurred by a single derivatives trader employed by the Singaporean arm of the Barings group.[35] The official inquiry found that the main reasons for the collapse of Barings were management failings within Barings and lack of appropriate internal controls.[36] In addition, it also found some failings in the Bank's performance as the lead supervisor of the

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29. BINGHAM REPORT, *supra* note 20, ¶ 3.8.

30. MAXIMILIAN J.B. HALL, HANDBOOK OF BANKING REGULATION AND SUPERVISION IN THE UNITED KINGDOM 133–34 (3d ed. 1999).

31. BINGHAM REPORT, *supra* note 20, ¶ 3.3.

32. *Id.* ¶¶ 3.4–3.5.

33. *Id.* ¶¶ 3.4–3.5. This issue had been carefully discussed in the WHITE PAPER ON BANKING SUPERVISION, 1985, Cmnd. 9695, which had preceded the Banking Act 1987. Brian Quinn, *The Influence of the Banking Acts (1979 and 1987) on the Bank of England's Traditional Style of Banking Supervision*, *in* BANK REGULATION AND SUPERVISION IN THE 1990S, at 1 (Joseph J. Norton ed., 1991).

34. *See* REPORT OF THE BOARD OF BANKING SUPERVISION INQUIRY INTO THE CIRCUMSTANCES OF THE COLLAPSE OF BARINGS (HM Stationary Office, 1995) [hereinafter COLLAPSE OF BARINGS REPORT].

35. NICK LEESON & EDWARD WHITLEY, ROGUE TRADER: HOW I BROUGHT DOWN BARINGS BANK AND SHOOK THE FINANCIAL WORLD (1996); LUKE HUNT & KAREN HEINRICH, BARINGS LOST: NICK LEESON AND THE COLLAPSE OF BARINGS PLC (1996).

36. COLLAPSE OF BARINGS REPORT, *supra* note 34, ¶¶ 13.10–13.12.

Barings group.[37] Like the previous BCCI collapse, Barings provided a graphic illustration of the difficult challenges facing national regulators attempting to supervise complex multinational banking groups. It also illustrated the need within a fragmented regulatory system for close contact and cooperation between banking and securities regulators in order to achieve effective supervision of financial supermarkets, whose businesses straddled the fuzzy boundaries between those sectors.[38]

While bank failures were reflecting badly on the Bank in its regulatory role, a growing consensus was emerging among politicians and economists in favor of giving the central bank monetary policy independence.[39] Central bank independence is regarded as a practical consequence of the new economic orthodoxy in which monetary policy is the main instrument for delivering price stability.[40]

The connection between monetary policy independence and the location of regulatory responsibility for the banking sector is that if the two functions are combined, regulatory concerns may create conflicts of interest that undermine policy independence.

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37. *Id.* ¶¶ 13.57–13.61.

38. *Id.* ¶ 14.44. The earlier collapse of a smaller bank (British & Commonwealth) in 1990 had also demonstrated the need for close cooperation between relevant regulatory bodies. In the light of subsequent events, Hall's comment on the British & Commonwealth situation was particularly percipient. Hall stated: "one can but wonder if institutional rather than functional regulation would be a better way of dealing with the myriad public interest considerations which arise in connection with the regulation and supervision of highly diversified financial conglomerates." HALL, *supra* note 30, at 189 n.134.

39. *See generally* LASTRA, *supra* note 17, at 10–62. The issue of central bank independence is also partly tied up with the euro-entry debate and entry conditions because Article 108 of the Treaty of Amsterdam requires the member state central banks which, along with the European Central Bank ("ECB"), form the European System of Central Banks ("ESCB") to be independent with regard to Treaty obligations. TREATY OF AMSTERDAM AMENDING THE TREATY ON THE EUROPEAN UNION, THE TREATIES ESTABLISHING THE EUROPEAN COMMUNITIES AND CERTAIN RELATED ACTS, Nov.10, 1997, art. 108, O.J. (C 340) 1 (1997).

40. LASTRA, *supra* note 17, at 13–18; Michael Taylor, *Central Bank Independence: The Policy Background, in* BLACKSTONE'S GUIDE TO THE BANK OF ENGLAND ACT 1998, at 19–20 (Michael Blair et al. eds., 1998); Hossein Samiei & Jan Kees Martijn, *Operational Independence and the Conduct of Monetary Policy in the United Kingdom, in* HOSSEIN SAMIEI ET AL., INTERNATIONAL MONETARY FUND: UNITED KINGDOM EXPERIENCE (IMF Staff Country Report No. 99/44, 1999).

Following Charles Goodhart and Dirk Schoenmaker,[41] Michael Taylor hypothesizes that a central bank might not want to adjust interest rates if to do so might trigger a number of bank failures for which it could be blamed. Separating the monetary policy and regulatory roles would remove this conflict and leave the central bank to determine monetary policy free from extraneous influences. But the arguments for and against separation of functions are finely balanced.[42] This view is not, however, universal. Arguments against separation include: the role of the central bank as lender of last resort; its oversight function in relation to the payment system; the need for consistency between monetary policy and banking supervision; and synergistic advantages in concentration of functions.[43] This debate indicates that a central bank will inevitably have continuing involvement in some aspects of the regulatory process because of its role in ensuring financial stability and, further, that the demarcation of its responsibilities and those of any other body that assumes a banking supervisory role is an issue that must be specifically addressed.

Practical events and the evolution of the public policy economic agenda in the 1980s and early 1990s thus provided various reasons for considering change in banking regulation. It should also be noted that U.K. banking law and regulation was significantly amended during this period in order to implement various new European Community ("EC") measures.[44] These changes — though very significant in their own right in that they removed internal barriers to the free operation of banking activities throughout the EU — did not have a major direct impact on the institutional framework of regulation and so they, and equivalent measures in securities and insurance law, do not require detailed examination here.[45] Their immediate relevance to the present discussion is that piecemeal changes to

41. Charles A.E. Goodhart & Dirk Schoenmaker, *Institutional Separation Between Supervisory and Monetary Agencies, in* CHARLES A.E. GOODHART, THE EMERGING FRAMEWORK OF FINANCIAL REGULATION 133, 141 (1998).

42. Taylor, *supra* note 40, at 20.

43. LASTRA, *supra* note 17, at 148–49.

44. *See* HALL, *supra* note 30, at 36.

45. *See generally id.* (providing an in-depth view of the evolution of supervisory practice and the structure of banking supervision in the U.K.); CHRISTOS HADJIEMMANUIL, BANKING REGULATION AND THE BANK OF ENGLAND (1996).

existing legislation and the addition of extra layers of regulation, such as those that took place in the 1980s and 1990s to implement EU measures, added to the complexity of the framework and to compliance costs. An advantage of a fundamental root-and-branch reform was that it would provide an opportunity for a thorough, principled assessment of how best to combine domestic and EU requirements into a coherent overall framework.[46]

B. Securities Regulation[47]

The history of the U.K. securities regulation in the 1980s and early 1990s paralleled that of banking regulation; it is the story of a system that was undermined by financial scandals that badly affected consumer confidence. It was also a complex system that exacerbated the problems involved in ensuring effective supervision of multi-function firms. The excessively fragmented regulatory infrastructure of the securities industry meant that firms were often regulated by more than one regulatory agency, with the consequence that the system was heavily dependent upon the quality and effectiveness of communications and cooperation between the regulators. To be sure, there was strong industry dissatisfaction with the system, because the presence of multiple regulators created an uncertainty as to boundaries and created inefficiencies.[48] From its inception, the regulatory regime was the target of persistent criticism. It was seen to be unwieldy and bureaucratic. The extremely detailed, legalistic style of early versions of regulatory rulebooks did little to enhance the reputation of those responsible for the regime.[49] When even the head regulator acknowledged in 1993 that many

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46. Alistair Darling, *The Regulation of the U.K. Insurance Industry*, 4 INT'L INS. L. REV. 171, 173 (1996).

47. This section draws upon FINANCIAL SERVICES AND MARKETS BILL (House of Commons Library Research Paper 99/68) June 24, 1999, *available at* http://www.parliament.uk/commons/lib/research/rp99/rp99-068.pdf [hereinafter FINANCIAL SERVICES AND MARKETS BILL].

48. Amelia C. Fawcett, *Examining the Objectives of Financial Regulation — Will the New Regime Succeed? A Practitioner's View, in* REGULATING FINANCIAL SERVICES AND MARKETS IN THE TWENTY FIRST CENTURY 37, 47 (Eilís Ferran & Charles A. E. Goodhart eds., 2001) [hereinafter REGULATING IN THE TWENTY FIRST CENTURY].

49. BEN PETTET, COMPANY LAW 340 (2001); Andrew M. Whittaker, *Legal Technique in City Regulation,* 43 CURRENT LEGAL PROBS. 35, 42 (1990).

of the criticisms were justified,[50] it became indisputable that the U.K.'s defective securities regulation system was in dire need of reform.

The source of the problems was the institutional structure established under the Financial Services Act 1986. Under the Act, ultimate regulatory responsibility for the financial services industry lay with a government department. However, most regulatory powers were delegated to the Securities and Investments Board ("SIB"), a private company limited by guarantee and financed by a levy on market participants.[51] The SIB set the overall framework of regulation but did not itself act as the direct regulator of most investment firms. Second tier regulators — of whom the self-regulatory organizations ("SROs") were the most prominent group — performed that function.[52] SROs were funded, and partly managed, by investment firms. For this reason the style of regulation established by the Financial Services Act 1986, was sometimes described as "self-regulation within a statutory framework."[53] Underlying the emphasis on self-regulation in this description was a political compromise designed to assuage the concerns of market participants. As was noted by Professor Gower, whose studies of U.K. securities regulation in the 1980s powerfully influenced the character of the regime, the intellectually appealing full statutory model could not be pursued at that time because it would have been unacceptable in light of prevailing market conditions.[54] The extent to which the system established under the Financial Services Act 1986 truly retained a self-regulatory character in practice is debatable.[55] That it was presented in this way however, soon had unfortunate repercussions. Many observers

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50. ANDREW LARGE, FINANCIAL SERVICES REGULATION: MAKING THE TWO TIER SYSTEM WORK 10 (1993).

51. Financial Services Act, 1986, c. 60, § 61 (Eng.).

52. LARGE, *supra* note 50, at 22, 45.

53. GUIDE TO FINANCIAL SERVICES REGULATION 27 (Barry A. K. Rider et al. eds., 3d ed. 1997); ALAN C. PAGE & ROBERT B. FERGUSON, INVESTOR PROTECTION 78–105 (1992).

54. LAURENCE CECIL BARTLETT GOWER, REVIEW OF INVESTOR PROTECTION: A DISCUSSION DOCUMENT 75–83 (1982).

55. Laurence Cecil Bartlett Gower, *"Big Bang" and City Regulation*, 51 MOD. L. REV. 1 (1988); Iain MacNeil, *The Future for Financial Regulation: The Financial Services and Markets Bill,* 62 MOD. L. REV. 725 (1999); Eilís Ferran, *Dispute Resolution Mechanisms in the U.K. Financial Sector,* 21 CIV. JUST. Q. 135, 137 (2002).

latched onto the self-regulatory dimension as a key reason why the regime failed to succeed.[56] Yet, while growing mistrust of self-regulation undoubtedly played a part in the events that unfolded over the following years,[57] the more potent seeds of the regime's destruction lay in the complex two-tier structure and in the fragmentation at the SRO level.

At the outset, there were five SROs; however, by 1994, only three remained — the Securities and Futures Authority ("SFA"), the Investment Managers' Regulatory Organisation ("IMRO"), and the Personal Investment Authority ("PIA").[58] Some of the changes to the institutional arrangements at the SRO level can be seen in a positive light, as being the dynamic response of a flexible and market-sensitive system to developments in the industry.[59] But it is also the case that much of the change was driven by dissatisfaction about overlaps and possible gaps in the areas of responsibilities of the original SROs.[60]

There were persistent concerns about the effectiveness of the SROs' efforts to prevent fraud and misconduct. The SROs attracted severe criticism for having failed to protect the interests of consumers in a number of high-profile financial scandals. These included the Maxwell affair, where the IMRO's failure to detect the theft of company pension fund assets by its controller, Robert Maxwell, was the target of particular complaint.[61] Another notorious problem that damaged the reputation of the regulatory agencies in the early 1990s was that of pension mis-selling, whereby investors were sold inappropriate pension investment products.[62] Julia Black and Richard Nobles describe the pensions mis-selling episode as a manifestation of "a critical

56. GOWER, *supra* note 54 at 13–16.

57. Alistair Alcock, *A Regulatory Monster,* 1998 J. BUS. L. 371, 375.

58. Financial Services Act, 1986, c. 60, § 10(2) (Eng.).

59. 4 Fin. Serv. Rep. (Sweet & Maxwell) ¶ 2-650 (Aug. 2000).

60. *Id.*

61. 2 SIR ROGER THOMAS ET AL., MIRROR GROUP NEWSPAPERS PLC. INVESTIGATIONS UNDER SECTION 432 (2) AND 442 OF THE COMPANIES ACT 1985 app. 9 (2001), provides a review of IMRO's work in relation to Maxwell group companies and of changes made at IMRO after the eventual discovery of Maxwell's fraudulent schemes. On the other hand, PETTET, *supra* note 49, at 341, presents a more positive assessment of the effectiveness of SRO disciplinary measures and the hard-hitting nature of their operations.

62. Gerard McMeel, *The Consumer Dimension of Financial Services Law: Lessons from the Pensions Mis-selling Scandal,* 3 COMPANY FIN. & INSOLVENCY L. REV. 29, 29 (1999).

failing in the regulatory structure" involving "regulatory blindness," "lack of awareness," and "lack of communication and co-operation between the different regulators."[63]

In a personal assessment published after the Maxwell affair, the then Chairman of the SIB, Andrew Large, identified a number of problems that were thought to afflict the regime he headed: lack of clarity about regulatory objectives; lack of confidence that self-regulation was anything other than self-interest; doubts about cost-effectiveness; and a feeling that fraud was going undetected.[64] Chairman Large's acknowledgement that many of these criticisms were justified set the agenda for policy discussions and political debate in the following years.[65] By the end of 1995, it was a clearly articulated Labour Party policy, then in opposition, to remove the last remnants of self-regulation and the "unnecessary" distinction between the SIB and the SROs.[66] It seems likely that a Conservative government would have traveled the same route had it remained in power. However, there was no indication at this stage of quite how radical the incoming Labour government would be. The case for a single regulator for the whole of the financial sector did not yet figure prominently in the discussions.

C. Insurance[67]

The regulation of the insurance industry in the 1980s and 1990s was a complex affair, yet it attracted little attention from policymakers (except in relation to the Lloyd's insurance market where there were particular problems). The prudential regulation and authorization of insurance companies were the responsibility of a government department under the Insurance

63. Julia Black & Richard Nobles, *Personal Pensions Misselling: The Causes and Lessons of Regulatory Failure,* 61 MOD. L. REV. 789, 789, 815 (1998).

64. LARGE, *supra* note 50, at 8.

65. *See, e.g.*, TREASURY AND CIVIL SERVICE COMMITTEE, THE SIXTH REPORT, 1995, cmt. 332, at vi.

66. *See* FINANCIAL SERVICES AND MARKETS BILL, *supra* note 47, at 17 (speech by Alistair Darling, the then Labour spokesman on the City). *See also* Darling, *supra* note 46, at 172.

67. *See generally* JOHN BIRDS & NORMA J. HIRD, BIRDS, MODERN INSURANCE LAW ch. 2 (5th ed. 2001); JOHN P. LOWRY & PHILIP RAWLINGS, INSURANCE LAW: DOCTRINES AND PRINCIPLES 348–66 (1999); Darling, *supra* note 46.

Companies Act 1982.[68] Long term insurance policies were treated as investments for the purposes of the Financial Services Act 1986 with the result that these aspects of insurance companies' business also fell within the scope of the regulatory regime established under that Act.[69] Insurance brokers were also subject to another form of self-regulation within a statutory framework[70] operated by a body known as the Insurance Brokers Registration Council. By the 1990s, the continuance of this degree of self-regulation was regarded as anomalous.[71] The Lloyd's insurance market had a special status under the Insurance Companies Act 1982[72] and an exemption under the Financial Services Act 1986.[73] Problems at Lloyd's in the early 1990s resulting from disastrous losses put its special regulatory status under scrutiny. Some observers suggested that by not being within the scope of the Financial Services Act 1986, Lloyd's lost out on access to the latest standards and methods of regulation and that, if it had been better regulated, the impact of the losses might have been less severe.[74] An internal review published in early 1997 recommended that Lloyd's should be

68. Insurance Companies Act, 1982 c. 50, § 3 (Eng.). *See also* Richard Croly, *The Regulatory Structure in the United Kingdom: The Role of the Department of Trade and Industry,* 1 INT'L INS. L. REV 349 (1993). Responsibility for regulation of the insurance industry was assumed by another government department, HM Treasury, in 1997 as a prelude to its transfer to the Financial Services Authority. Press Release, HM Treasury, Working Towards a Single Financial Regulator (July 30, 1998) *available at* www.hm-treasury.gov.uk/newsroom_and_speeches/press/1998/press_127_98.cfm.

69. *See generally* GUIDE TO FINANCIAL SERVICES REGULATION 370–86 (Barry A. K. Rider et al. eds., 3d ed. 1997).

70. Insurance Brokers Registration Act, 1977, c. 46 (Eng.) (repealed 2001).

71. ANDREW MCGEE, THE MODERN LAW OF INSURANCE 21 (2001); Richard Spiller, *Insurance: Broker Regulation*, 6 INT'L INS. L. REV N-67, at N-67 to N-68 (1998).

72. Insurance Companies Act, 1982, c. 50, § 2(2)(a) (Eng.).

73. Financial Services Act, 1986, c. 60, Pt. I, c. IV, § 42 (Eng.).

74. David Gittings, *Lloyd's of London: The Regulation of an International Insurance Market,* 1 J. INT'L FIN. MARKETS 72, 74–75 (1999); Darling, *supra* note 46, at 172. The U.K. government's oversight of the Lloyd's insurance market during the 1980s is the subject of an ongoing investigation by the European Commission. However, the investigation focuses more on whether the system of regulation has been improved by the Financial Services and Markets Act 2000, than on holding the U.K. to account for past mistakes. Andrew Osborn, *Court Hopes Dented for Lloyd's Names,* GUARDIAN (London), Oct. 8, 2002, at 24.

brought within the regulatory jurisdiction of the SIB.[75] The proposal was soon swept up into the radical new approach to financial regulation announced by the new Labour government in May 1997.

D. All Change

The new Labour government was elected on May 1, 1997. On May 6, 1997 the Chancellor of the Exchequer, Gordon Brown, announced that he was giving monetary policy independence to the Bank.[76] This was followed on May 20 by a further announcement from the Chancellor, in which he announced the transfer of responsibility for banking regulation and supervision from the Bank of England to the SIB, as well as reform of the regulatory structure introduced by the Financial Services Act 1986. According to the Chancellor: "SIB will become the single regulator underpinned by statute. The current system of self-regulation will be replaced by a new and fully statutory system, which will put the public interest first, and increase public confidence in the system."[77] The instigation of regulatory reform in itself was no surprise, but that it took the form of a switch to a single regulator was unexpected and politically contentious,[78] not least because the Governor of the Bank had not been consulted about the proposals to strip the Bank of its regulatory role.[79] Previous statements from Labour Party spokesmen had suggested more modest, incremental change concen-

75. *See* Gittings, *supra* note 74, at 75.

76. Gordon Brown, Statement by the Chancellor on the Central Economic Objectives of the New Government (May 6, 1997), *at* http://www.hm-treasury.gov.uk/Newsroom_and_Speeches/speeches/statement/speech_statement_index.cfm? The background to this announcement and its consequences are discussed generally in the House of Lords Select Committee Report, MONETARY POLICY COMMITTEE OF THE BANK OF ENGLAND REPORT, 1999, *available at* http://www.publications.parliament.uk/pa/ld199899/ldselect/ldmon/96/9601.htm (last visited Nov. 12, 2002).

77. Gordon Brown, The Chancellor's Statement to the House of Commons on the Bank of England (May 20, 1997), *at* http://www.hm-treasury.gov.uk/Newsroom_and_Speeches/speeches/statement/speech_statement_index.cfm? [hereinafter Chancellor's Statement on the Bank of England].

78. FINANCIAL SERVICES AND MARKETS BILL, *supra* note 47, at 20–25.

79. On the political fallout of the decision, see ANDREW RAWNSLEY, SERVANTS OF THE PEOPLE: THE INSIDE STORY OF NEW LABOUR 41–44 (2000).

trating, in particular, on dismantling the two-tier structure under the Financial Services Act 1986.[80]

According to the Chancellor's statement, there were three key reasons for the new approach: (1) The existing system was failing to deliver the standards of investor protection and supervision that the industry and the public had the right to expect; (2) The two tier structure under the Financial Services Act 1986 was inefficient, confusing, and lacked accountability and a clear allocation of responsibilities; and (3) The need for a regulatory structure that would reflect the nature of the markets where the old distinctions between banks, securities firms, and insurance companies had become increasingly blurred.[81] The first two reasons were predictable, given the local historical record. The third reason had not previously enjoyed the same degree of prominence. Although matching the nature of the national regulator to the nature of the markets is now the familiar centerpiece of discussions about the institutional framework of regulation, in the political debates on financial regulation in the U.K. in the 1990s it was not an issue that had attracted particular attention.

So why was the single market/single regulator argument raised to such a prominent position by the British Chancellor? The full answer to this question may well remain unknown until current political figures publish their memoirs or until confidential political records are finally released. Mark Boléat, who was the then Director-General of the Association of British Insurers, however, has put forward one plausible theory. Boléat suggests that the decision to opt for a single regulator was driven more by pragmatic considerations relating to pressures on the parliamentary timetable than by principle:

> The Treasury team had failed to secure in the first Queen's Speech legislation to abolish the two tier system under the Financial Services and Markets Act. However, a separate decision had been taken to give the Bank of England independence in respect of conducting monetary policy and this did require legislation. It seems that an opportunist decision was taken at this stage to move towards a single regulator because the legislation to give the Bank of England independence in respect

80. Darling, *supra* note 46, at 172.
81. Chancellor's Statement on the Bank of England, *supra* note 77.

> of monetary policy could be used for any other purpose relevant to the Bank of England.[82]

Initial proposals were very sketchy and important industry sectors, including, for a brief time, insurance,[83] and, for a much longer time, mortgage lending,[84] were not part of the remit originally envisaged for the new regulator.[85] This credits the theory that the switch to a single regulator was a policy decision made "on the hoof" in response to political pressures unconnected to the evolving nature of financial markets.[86] Another theory that has also been suggested is that personal antagonism between the Chancellor of the Exchequer and the Governor of the Bank also played a part in driving the decision to divest the Governor of his institution's regulatory powers.[87]

For observers trying to discover what lessons can be learned from the U.K. experience in adopting the single regulator model, the clearest point that emerges from this brief historical survey up to 1997 is confirmation of the influence of intensely local, country-specific factors in decisions about institutional structures. But May 1997 is too soon to leave the story. Although the decision itself may have been taken opportunisti-

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82. Mark Boléat, The New System of Financial Regulation, Speech at the London Insurance Institute (Nov. 25, 1998).

83. The inclusion of insurance in the new structure was announced in July 1997. Press Release, Department of Trade and Industry, Future Regulation of the Insurance Industry (July 23, 1997), *available at* http://www.newsrelease-archive.net/coi/depts/GTI/coi1035d.ok.

84. JOINT COMMITTEE ON FINANCIAL SERVICES AND MARKETS, DRAFT FINANCIAL SERVICES AND MARKETS BILL: FIRST REPORT ¶ 84 (HL Paper 50-I, HC 328-I, 1999) [hereinafter JOINT COMMITTEE FIRST REPORT], recommended that mortgages should be brought within the scope of the new regime. In response, HM Treasury conducted a consultation exercise with the publication of HM TREASURY, REGULATION OF MORTGAGES: A DISCUSSION DOCUMENT BY HM TREASURY (July 20, 1999). Following this consultation exercise, the decision was made to include mortgages, and power to extend the regime in this way was included in the Financial Services and Markets Act 2000. However, so as not to over burden the FSA in its early days, its assumption of powers in relation to mortgage business was postponed. The FSA currently expects to begin regulating mortgage lenders and advisers by mid-2004. FINANCIAL SERVICES AUTHORITY, TIMETABLE FOR THE REGULATION OF MORTGAGES AND GENERAL INSURANCE (2003), *available at* http://www.fsa.gov.uk/mort_gen_ins/mgi_timetable.pdf.

85. *See also* Alcock, *supra* note 57, at 372, 375.

86. *Id.*

87. RAWNSLEY, *supra* note 79, at 41–44.

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cally without full consideration of all of its implications, its announcement was a highly significant event. It intensified debate amongst theorists, inside and outside the U.K., about different institutional structures for financial regulation.[88] At the same time, the challenges involved in turning the single regulator model into practical reality soon became a major preoccupation for industry participants.

III. PUTTING POLICY INTO EFFECT — CREATING A NATIONAL SINGLE REGULATOR[89]

The first stage in the reform process was the renaming of the SIB as the Financial Services Authority ("FSA") in October 1997.[90] Thereafter, most of the existing regulatory agencies collapsed themselves into the FSA structure on a largely informal and ad hoc basis.[91] In effect, the FSA assumed the de facto role of single regulator.[92] But for a transitional period ending on December 1, 2001, the FSA's powers were mostly derived from the old legislation under which the previous fragmented regimes had operated.[93] One important exception was in the banking field, where regulatory and supervisory responsibilities were formally passed to the FSA in June 1998 under the Bank of England Act 1998.[94] However, the 1998 Act merely transferred existing powers without significant amendment. The FSA, as the renamed SIB, was, and still remains, in form, a company limited by guarantee.[95]

88. For a general survey see GOODHART ET AL., *supra* note 12, at 142–88.

89 Lomnicka, *supra* note 19.

90. See FINANCIAL SERVICES AUTHORITY, CONSUMER INVOLVEMENT (1997), *available at* http://www.fsa.gov.uk/pubs/cp/cp01.pdf, for a summary of enabling legislation and background.

91. Howard Davies, *Law and Regulation,* 3 J. INT'L FIN. MARKETS 169, 169 (2001) [hereinafter Davies, *Law and Regulation*].

92. Formally, the FSA acted as the sub-delegate of existing regulatory agencies. *See* FINANCIAL SERVICES AUTHORITY, CONSUMER INVOLVEMENT app. I (1997), *available at* http://www.fsa.gov.uk/pubs/cp/cp01.pdf.

93. FINANCIAL SERVICES AUTHORITY, *at* http://www.fsa.gov.uk/history (last visited Feb. 19, 2003).

94. Bank of England Act, 1998, § 3, sched. 4 (Eng.). *See also* Davies, *Law and Regulation*, *supra* note 91, at 170; Heidi Mandanis Schooner & Michael Taylor, *Convergence and Competition: The Case of Bank Regulation in Britain and the United States*, 20 MICH. J. INT'L L. 595, 646 (1999).

95. Financial Services and Markets Act, 2000, c. 8, §§ 13–14, 17 (Eng.).

The process of vesting full powers in the FSA as single regulator began in July 1998 with the publication of the Financial Services and Markets Bill in draft form.[96] A period of consultation with industry participants, consumer groups, and other interested parties followed. The most significant part of the public consultation process was the establishment in February 1999 of a Joint Committee of both Houses of Parliament to scrutinize the draft Bill — the first time a Joint Committee had been charged with this task.[97] The Joint Committee, under the Chairmanship of Lord Burns, a former chief civil servant at HM Treasury ("Treasury"), opened paper submission on certain major issues arising from the draft Bill.[98] In addition, the Joint Committee held sessions of oral evidence. The witnesses at these sessions included representatives from the government, the FSA, investment and commercial banks, insurers, consumer groups, and law firms.[99] A novel feature of the oral evidence sessions was that they were run as discussions with fellow panelists allowed to respond to each other's comments and suggestions rather than just responding to questions from members of the Joint Committee. To facilitate discussion, the head of the Treasury Bill team and the Deputy General Counsel of the FSA attended all of the sessions.[100] The Joint Committee's method of conducting its consultation process and the two reports which it produced at the end of its deliberations attracted widespread praise.[101] The Joint Committee was thought to have clarified a number of key issues, in particular the impact of the European Convention on Human Rights on the disciplinary and enforcement procedures of the new regime.[102] This issue was highly

96. Press Release, FSA, Publication of the Draft Bill (July 30, 1998).

97. JOINT COMMITTEE FIRST REPORT, *supra* note 84.

98. Joint Committee on Financial Services and Markets, Press Notice No. 2 of Session 1998–99 (Mar. 10, 1999).

99. JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶ 6, Minutes of Evidence.

100. Joint Committee on Financial Services and Markets, Press Notice No. 3 of Session 1998–99 (Mar. 19, 1999); JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶ 6.

101. JOINT COMMITTEE FIRST REPORT, *supra* note 84. *See also* JOINT COMMITTEE ON FINANCIAL SERVICES AND MARKETS, DRAFT FINANCIAL SERVICES AND MARKETS BILL, PARTS V, VI AND XII IN RELATION TO THE EUROPEAN CONVENTION ON HUMAN RIGHTS, SECOND REPORT (1999).

102. Davies, *Law and Regulation*, *supra* note 91, at 170.

topical because the Human Rights Act 1998 was about to bring the Convention more fully into effect under British law.[103]

Although it achieved some notable successes, the Joint Committee sat only for a couple of months and, in the limited time period available, it was able to deal only with selected aspects of the new legislation.[104] The debate then moved into the main chambers of both Houses of Parliament. After a laborious and sometimes controversial passage through Parliament,[105] the Bill finally received Royal Assent in June 2000.[106] However the Financial Services and Markets Act 2000 ("FSMA") provides only the framework of the new regime. The elaborate and extensive details of the regime are contained in secondary legislation, statutory instruments made by the Treasury, and in rules made by the FSA.[107] The process of filling in the details occupied the period from Royal Assent until December 1, 2001 (a date known as "N2"), when the new regime finally came into effect.[108]

Thus, although the FSA has been de facto operational in some form since 1997, it has enjoyed its full powers for only a relatively brief period. This creates an unusual situation. On the one hand, the FSA has had time to establish itself and to begin to build its own identity and methods of operation. Industry, consumers, and the media have had time to experience the reality of dealing with the FSA as a quasi-single regulator and views have formed on how it is shaping up to the task.[109] On

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103. Human Rights Act, 1998, c. 42 (Eng.).

104. *See generally* Davies, *Law and Regulation*, *supra* note 91; JOINT COMMITTEE FIRST REPORT, *supra* note 84.

105. According to *The Sunday Telegraph*: "[T]he Bill to set up the super regulator was one of the most tortuous pieces of legislation in Parliamentary history." Grant Ringshaw, *Crackdown in the City Slapped Wrists or Heads on Spikes?,* SUNDAY TELEGRAPH, Nov. 25, 2001, at 5.

106. Financial Services and Markets Act, 2000, c.8, Enactment Clause (Eng.).

107. *See generally* HM Treasury, *Financial Services*, *at* http://www.hm-treasury.gov.uk/documents/financial_services (last visited Feb. 19, 2003); FSA HANDBOOK, *available at* http://www.fsa.gov.uk/handbook (last modified Mar. 3, 2003).

108. Press Release, Financial Services Authority, FSA Consults on Proposed Fees for New Regime (Sept. 21, 2001), *at* http://www.fsa.gov.uk/pubs/press/2001/120.html; *A Cut-Out-and-Keep Guide to the FSA,* DAILY TELEGRAPH, Dec. 1, 2001, at 35.

109. Howard Davies has described the situation in these terms: "[E]ven before it takes on its new powers, the FSA has acquired a reputation of sorts,

the other hand, views on the performance of the FSA as a single regulator must necessarily be qualified to take account of the fact that it has had its full powers for only a short period of time. The distorting effect of the process of preparing for the new regime must also be considered. The massive task of putting in place the detailed aspects of the regime in the transitional period between 1997 and 2001 undoubtedly diverted resources and attention away from the task of practical delivery of regulation. This means that it would clearly be premature to attempt to say whether the FSA is really delivering in practice the benefits claimed for a single regulator while avoiding the problems that this structure may create. But the U.K.'s experience of living with a quasi-single regulator and, at the same time, making the transition to a formal single regulator is still worth examining further. A remarkable combination of processes were occurring simultaneously: The development of theoretical arguments for and against a single regulator were evolving within the context of a market that was already waking up to the reality of living with a de facto single regulator, and all of these influences were feeding into the political processes through which the new regime was to acquire its legal basis and powers.[110] The U.K. experience between 1997 and 2001 thus provides a valuable case study for testing theoretical arguments about the merits and drawbacks of the single regulator model and for demonstrating how those positive and negative features can be addressed in the legal framework by which the model is introduced.

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built on its performance as a caretaker, rather than as a principal." Davies, *Law and Regulation*, *supra* note 91, at 169.

110. *See, e.g.,* BRIAULT, THE RATIONALE, *supra* note 8, at 6–9; Davies, *Law and Regulation*, *supra* note 91, at 169–70.

IV. HOW IS THE NEW REGIME SHAPING UP? USING THE U.K. EXPERIENCE TO TEST AND EXAMINE THE LEGISLATIVE AND PRACTICAL RESPONSES TO THEORETICAL CONCERNS

A. A Single Financial Regulator is Superior because it Mirrors the Nature of the Participants and Products in Financial Markets

This is a prominent argument in favor of the single regulator model.[111] The proposition that a single regulator is advantageous because it mirrors the nature of modern financial markets, where old distinctions between different sectors and different products have broken down, certainly has logical superficial attraction. However, some commentators have cautioned that the trend towards industry consolidation should not be exaggerated.[112] Although some firms are genuine financial supermarkets with major areas of activity in more than one of the main sectors of banking, securities, and insurance, many others remain dominated by their "core" business, despite some diversification into other sectors.[113] For such firms, the risk that concentration of regulatory responsibility will result in loss of regulatory diversity and valuable sector-specific knowledge and expertise, may not be counterbalanced in practice by a significant reduction in the number of regulatory agencies with which they have to deal.

Was the adoption of the single regulator model interpreted by market participants as simplification of regulation for major financial groups operating across sectors at the expense of more sector-specialized firms and institutions? Or was it viewed by consumer groups as a move driven by the demands of certain sections of the financial services industry for a system of regulation that would be more convenient for them rather than for

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111. *See* Chancellor's Statement on the Bank of England, *supra* note 77; BRIAULT, THE RATIONALE, *supra* note 8, at 12–17.

112. Alcock, *supra* note 57, at 376; GOODHART ET AL., *supra* note 12, at 153.

113. GOODHART ET AL., *supra* note 12, at 153. *See also* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks,* 2002 U. ILL. L. REV. 215, 254–55 (pointing out that the U.S. banking industry has separated into two sectors: the global sector involving a small group of very large banks providing the services of financial supermarkets; and the community sector comprising a few thousand smaller banks that provide personalized financial services to small businesses and moderately affluent customers).

the needs of consumers of financial services? It appears not. According to a progress report published by the Treasury in March 1999, the single statutory regulator proposal had attracted almost unanimous support.[114] The influential Joint Committee on Financial Services and Markets supported the principle of a single regulator on the basis of the written and oral evidence presented to it.[115] The proposal also attracted favorable comment from the International Monetary Fund ("IMF").[116] The comparative merits of alternative regulatory structures that had generated some debate[117] were quickly sidelined in the practical and political processes leading up to the adoption of the single regulator model in the U.K.[118]

One key reason why there was no serious objection to the principle of the single regulator may have been that it had the great merit of simplicity. Many of the failings, real or perceived, of the predecessor regimes flowed from their inherent complexity. The switch to a single regulator marked a decisive and radical break with the past. Moreover, in political terms it was clear that adoption of the single regulator was "non-negotiable" and that the Labour government's large majority in Parliament would ensure the safe passage of the relevant legislation.[119] Pragmatically, it made no sense for lobbying groups to direct their efforts at challenging the basic idea of the single regulator since that battle was already lost.[120] From the con-

114. HM TREASURY, FINANCIAL SERVICES AND MARKETS BILL: PROGRESS REPORT ch. 2 (1999), *available at* http://finaserv02.uuhost.uk.uu.net/development/legal/fsma/data/progress_report/progress_report.htm (last visited Nov. 13, 2002).

115. JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶ 102.

116. IMF Concludes Article IV Consultation with the United Kingdom, IMF Pub. Info. Notice No. 99/17 (Mar. 7, 1999), *at* http://www.imf.org/external/np/sec/pn/1999/pn9917.htm.

117. *See* GOODHART ET AL., *supra* note 12, at 142–88; MICHAEL TAYLOR, CENTRE FOR THE STUDY OF FINANCIAL INNOVATION, TWIN PEAKS: A REGULATORY STRUCTURE FOR THE NEW CENTURY (1995) [hereinafter TAYLOR, TWIN PEAKS]; MICHAEL TAYLOR, CENTRE FOR THE STUDY OF FINANCIAL INNOVATION, PEAK PRACTICE: HOW TO REFORM THE U.K.'S REGULATORY SYSTEM (1996).

118. Howard Davies, *Reforming Financial Regulation: Progress and Priorities, in* REGULATING IN THE TWENTY FIRST CENTURY, *supra* note 48, at 19 [hereinafter Davies, *Reforming Financial Regulation*].

119. *Id.*

120. Secondary battles about the scope of the regime, the powers of the single regulator, and, in particular, the accountability of a single regulator were waiting to be fought. *See infra* notes 145-243 and accompanying text.

sumer perspective, the new system offered the prospect of a "one stop shop" for complaints and redress via a unified financial services ombudsman, and that had strong appeal.[121]

Does adoption of the single regulator model necessarily mean that regulation will actually operate seamlessly unimpeded by old sectoral boundaries? In part, this question is unanswerable at this juncture because it involves an assessment that can only be made with the benefit of data arising from practical experience. However, some observations arise from the processes leading up to the formal establishment of the FSA and relating to the arrangements as now in place.

At the policy level, the FSA has made considerable efforts to establish its credentials as a single regulator in substance, as well as in form, by emphasizing its new integrated approach to regulation.[122] It has adopted a single risk-based approach for use across all regulated sectors, markets, and firms. In this context, "risk" has an unusual interpretation.[123] It used to mean risk that the FSA will fail to achieve its statutory regulatory objectives. The FSA's standard risk assessment process involves scoring the risk against a number of probability and impact factors.[124] The systemic nature of the firm is a relevant factor in the assessment process because maintaining confidence in the financial system, which embraces systemic risk concerns, is one of the statutory objectives.[125] However, the FSA has emphasized the "assessment of all risks has to be coordinated, in order to gauge the overall threat to our objectives."[126]

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121. JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶¶ 282–96. See Ferran, *supra* note 55, on the implementation of the unified ombudsman scheme and some early assessment of its performance.

122. FINANCIAL SERVICES AUTHORITY, A NEW REGULATOR FOR A NEW MILLENNIUM 29 (2000), *available at* http://www.fsa.gov.uk/pubs/policy/p29.pdf [hereinafter NEW REGULATOR FOR A NEW MILLENNIUM]; FINANCIAL SERVICES AUTHORITY, BUILDING THE NEW REGULATOR: PROGRESS REPORT 2, ¶¶ 59–63 (Feb. 2002), *available at* http://www.fsa.gov.uk/pubs/policy/bnr_progress2.pdf.

123. *See* Howell E. Jackson, *Regulation in a Multi-Sectored Financial Services Industry: An Exploratory Essay,* 77 WASH. U. L.Q. 319, 332–34 (1999) (Part II.A. discusses more common interpretations of "risk" in the context of financial regulation).

124. NEW REGULATOR FOR A NEW MILLENNIUM, *supra* note 122, at 15.

125. *Id.* at 15, 17.

126. *Id.* at 15.

The new risk-based approach to regulation is currently being phased in,[127] so it is obviously too early to gauge whether the FSA has the organizational capacity to deliver an integrated regulatory approach. The signs are good for those financial conglomerates that are regulated by the FSA's Major Financial Groups Division, because that division has been established specifically to "take a coherent and integrated approach to the supervision of these groups."[128] An integrated approach is less obvious in other parts of the FSA's internal departmental structure, which continue to be organized along broadly sectoral lines.[129] The FSA lead regulator model — inherent in the predecessor regimes — is employed to deal with groups that operate predominantly in one sector but with some entities operating in other sectors.[130] This structure is sensible to the extent that, under the single regulator umbrella, it allows for sensitive, differentiated regulation of businesses that are predominantly active only in one sector. In the transitional period, it may have facilitated smooth implementation of the single regulator model because it allowed the staff employed in the previous fragmented structure to continue to work in their area of specialization which, in turn, gave comfort to regulated firms about continuity in practical, day-to-day relationships with

127. The fact that the FSA had not completed the rolling out of its risk based approach was at the center of its dispute with Fitch in June 2002 in which the FSA stated that Fitch's report to the effect that 25% of the U.K.'s insurers had been placed in a higher risk category was a misinterpretation of FSA data. Jill Treanor, *Regulator Calls Fitch "Plain Wrong": FSA Denies Insurers are "Higher Risk,"* GUARDIAN (London), June 14, 2002, at 25.

128. FINANCIAL SERVICES AUTHORITY, INTRODUCTION TO THE FINANCIAL SERVICES AUTHORITY 13 (2001), *available at* http://www.fsa.gov.uk/pubs/other/fsa_intro.pdf [hereinafter INTRODUCTION TO THE FSA]. A report commissioned by the Centre of the Study of Financial Innovation and published in May 2001 indicated that the larger City institutions, particularly those classified as major financial groups, expected to see the greatest benefit of the single regulator structure and that some already were. *See* DAVID LASCELLES, CENTRE FOR THE STUDY OF FINANCIAL INNOVATION, WAKING UP TO THE FSA: HOW THE CITY VIEWS ITS NEW REGULATOR 13 (2001) [hereinafter CSFI, WAKING UP TO THE FSA].

129. *See* INTRODUCTION TO THE FSA, *supra* note 128, at 24 (FSA Organisation Chart).

130. FINANCIAL SERVICES AUTHORITY, LEAD SUPERVISION: THE FSA'S NEW APPROACH TO THE CO-ORDINATION OF ITS SUPERVISION OF GROUPS 5 (1999), *available at* http://www.fsa.gov.uk/pubs/policy/p19.pdf.

their regulators.[131] But it could prove problematic in the longer term, if it facilitates the continuation of ingrained methods and practices that are, in principle, incompatible with the achievement of a truly integrated approach to regulation. Here, again, there are some positive signs coming from FSA pronouncements about insurance regulation, which emphasize that risk-based assessment means a wholly new approach within its insurance division.[132] However, it should be noted that the FSA is under particular pressure to signal a fresh start in insurance regulation because of recent crises in the insurance sector involving both failing firms[133] and defective products,[134] for which the FSA

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131. Alcock, *supra* note 57, at 377.

132. FINANCIAL SERVICES AUTHORITY, THE FUTURE REGULATION OF INSURANCE: A PROGRESS REPORT (Oct. 2002) at 19, *available at* http://www.fsa.gov.uk/pubs/policy/bnr_progress3.pdf; FINANCIAL SERVICES AUTHORITY, THE FUTURE REGULATION OF INSURANCE (Nov. 2001), *available at* http://www.fsa.gov.uk/pubs/other/future-reg_insurance.pdf; Alex Brummer, *Spotlight Falls on Insurance*, DAILY MAIL, Dec. 4, 2001, at 67 (reporting the head of the FSA's insurance side as taking the view that a whole new approach to insurance supervision based upon risk assessment is needed); Robert Preston, *City Watchdog Who Bites but Won't Bark*, SUNDAY TIMES (London), Mar. 17, 2002 (reporting Howard Davies, the Chairman of the FSA, as identifying the imperative of modernizing insurance regulation, which was "a generation behind banking supervision and securities regulation").

133. Equitable Life, the world's oldest mutual life assurance company closed to new business in December 2000 following a court case, Equitable Life Assurance Soc'y v. Hyman, [2002] 1 A.C. 408 (H.L.), in which the House of Lords ruled against the company in its interpretation of certain of its pension policies thereby plunging the company into extreme financial difficulties. Independent Insurance, a general insurance company, collapsed in June 2001 after the failure of efforts to raise additional capital. These were headline-grabbing major collapses but according to FSA data, as of January 2002, thirty-nine general insurers were in formal insolvency proceedings in the U.K., with quantified gross insurance liabilities of £12.5 billion. *See generally* Howard Davies, "Rational Expectations" — What Should the Market, and Policyholders, Expect from Insurance Regulation?, AIRMIC Annual Lecture (Jan. 29, 2002), *available at* http://www.fsa.gov.uk/pubs/speeches/sp87.html.

134. In particular, the problem of mis-selling endowment policies, which surfaced in the late 1990s (i.e., life assurance policies which were sold in conjunction with mortgages as a mechanism for repayment of mortgage principal at the end of its life but without clear disclosure to customers that there was no guarantee that the policies would in fact generate an amount sufficient to cover the mortgage debt). According to the FSA, by 2000 an estimated 60% of the 11 million existing mortgages were no longer on track to repay the mortgage loan. FINANCIAL SERVICES AUTHORITY, PROGRESS REPORT ON MORTGAGE ENDOWMENTS ¶ 2.18 (Oct., 2000), *available at* http://www.fsa.gov.uk/pubs/policy/p19.pdf.

has had to shoulder some blame[135] as well as attracting significant criticism from politicians and the media.[136]

Mis-selling allegations also surround another underperforming financial product — split capital trusts. *See* FINANCIAL SERVICES AUTHORITY, SPLIT CAPITAL CLOSED END FUNDS ¶¶ 5.11, 5.15 (Dec. 2001), *available at* http://www.fsa.gov.uk/pubs/discussion/dp10.pdf; FINANCIAL SERVICES AUTHORITY, SPLIT CAPITAL INVESTMENT TRUSTS (SPLITS) ¶ 3.7 (May 2002), *available at* http://www.fsa.gov.uk/pubs/policy/pssplits/pdf; Ingrid Mansell, *FSA Launches Investigation into Mis-selling of Splits*, TIMES (London), May 18, 2002, at 43.

135. The FSA's internal audit of the regulator's role in regulating Equitable Life between 1999 and 2000 identified deficiencies in FSA regulation, in particular with regard to communication between prudential and conduct of business regulators. REPORT OF THE FINANCIAL SERVICES AUTHORITY ON THE REVIEW OF THE REGULATION OF THE EQUITABLE LIFE ASSURANCE SOCIETY FROM 1 JANUARY 1999 TO 8 DECEMBER 2000, WHICH HER MAJESTY'S GOVERNMENT IS SUBMITTING AS EVIDENCE TO THE INQUIRY CONDUCTED BY LORD PENROSE ¶ 6.2.5 (2001) [hereinafter BAIRD REPORT]; Press Release No. 57/01, Parliamentary Ombudsman to Investigate Financial Services Authority's Handling of Equitable Life (Oct. 29, 2001), *available at* http://ombudsman.org.uk/pca/press/pn57-01.htm. Following this report, the government established its own independent inquiry. *See* HM Treasury Press Release 113/01, Government Response to FSA Report on the Regulation of Equitable Life, (Oct. 17, 2001), *available at* http://www.hm-treasury.gov.uk/Newsroom_and_Speeches/Press/2001/Press_113.01.cfm. The Parliamentary Ombudsman is also investigating the FSA's handling of the collapse. *See* James Moore, *Ombudsman to Investigate FSA Role at Equitable*, TIMES (London), Oct. 30, 2001, at 24. If the Ombudsman finds the FSA guilty of maladministration, the government could be directed to compensate policyholders.

With regard to the Independent Insurance collapse, press reports indicate that the FSA is to be sued by the company's policyholders for its role in the handling of the collapse. Gary Parkinson, *Independent Holders Sue FSA,* DAILY TELEGRAPH (London), Mar. 13, 2002, at 38.

136. In relation to endowment mis-selling, the FSA was criticized in the press for not launching a full-scale review akin to that which had been conducted previously in relation to pensions mis-selling. In some quarters this was interpreted as the FSA bowing to industry pressure rather than championing consumer interests. The FSA's attempts to diffuse the situation by publishing guidance to firms on dealing with endowment-related complaints and making redress to those with legitimate claims did not stem the flow of critical press coverage. *See, e.g.*, David Prosser & Neasa MacErlean, *Cash: Where's the Rest?: The Endowment Crisis Has Hit Millions Yet Regulators Refuse a Full Review,* OBSERVER, Sept. 2, 2001, at 2. Findings from a year-long FSA review of the profits industry were also criticized by consumer groups, with suggestions that the FSA had kowtowed to industry in its recommendations. Emma Simon, *The Great With-profits Fudge: The FSA's Report on its Investigation*, SUNDAY TELEGRAPH, June 2, 2002, at 4.

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The flip-side of the argument that a single regulator will fail in practice to deliver an integrated regulatory approach, is that it will pursue integration over-enthusiastically thereby failing to make appropriate differentiation between businesses that mainly operate in different sectors, or between businesses within the same sector but which have very different customer bases. A single regulator is obviously vulnerable to attack on this ground but, thus far, criticism of the FSA on the ground that it is attempting to impose a "one-size-fits-all" approach has been muted.[137] The FSA has helped its own cause in this respect by explicitly introducing a differentiated regime, which uses the nature of the counterparty with whom a firm deals as the basis for determining the applicable level of conduct for business regulation.[138] This approach allows for "light touch" regulation of business between market professionals.[139] It has been welcomed as restoring "some of the differentiation that was inherent in the City's old regime."[140]

B. A Single Regulator Should Be Able to Deliver Efficiency Gains

There are several strands to the argument that the single regulator model may be superior to alternative regulatory structures on efficiency grounds.[141] Efficiency in this context

137. *See* CSFI, WAKING UP TO THE FSA, *supra* note 128, at 4, 14–15 (reporting some fears about the growth of a mono-culture and excessive zeal for harmonization but suggesting that any loss in regulatory diversity has been offset by greater consistency).

138. FSA HANDBOOK, *available at* http://www.fsa.gov.uk/handbook (last modified Mar. 3, 2003); Market Conduct Sourcebook *available at* www.fsa.gov.uk/handbook/legal_instruments/2001/jun21_mar.pdf (last modified Sept. 24, 2002); The Inter-Professionals Code (FSA Consultation Paper 47, 2002) *available at* www.fsa.gov.UK/pubs/CP/47 (last modified July 25, 2002).

139. Edward Black & Emma Radmore, *CP47 — The Inter-professionals Code,* 1 FIN. SERVICES BULL. 11 (2000).

140. CSFI, WAKING UP TO THE FSA, *supra* note 128, at 15.

141. *See generally* BRIAULT, THE RATIONALE, *supra* note 8, at 18–22; CLIVE BRIAULT, REVISITING THE RATIONALE FOR A SINGLE NATIONAL FINANCIAL SERVICES REGULATOR 14–15, 27–31 (FSA Occasional Paper No. 16, 2002), *available at* http://www.fsa.gov.uk/pubs/occpapers/index-2002.html [hereinafter BRIAULT, REVISITING THE RATIONALE]; Leonardo Bartolini, *The Financial Services Authority: Structure, Mandate and Policy Issues, in* HOSSEIN SAMIEI

relates to the manner in which the regulator deploys its own internal resources.[142] This is closely linked to the efficiency of its regulation and supervision, which relates to the wider economic impact of its activities, including compliance costs for regulated firms.[143]

A single regulator's position allows it to look across the entire financial industry and devote regulatory resources to where they are most needed. These include human, as well as financial, resources: the single regulator model should facilitate efficient use of available expertise and experience, a factor that may be particularly significant where such expertise and experience are in short supply. Economies of scale and scope should be possible because the single regulator has a unified management structure; can take advantage of unified central support services; introduce single databases and reporting systems; develop a single set of rules; and adopt consistent policies that are informed by its ability to take a market or industry-wide perspective.[144] A single regulator should, in principle, be able to avoid wasteful duplication and overlap. Economic literature, however, provides plenty of evidence to support counter-arguments about the economics of scale offered by mega-regulators.[145] It is also pointed out in the literature that the direct cost savings available by having a single institutional infrastructure, may be "a comparatively small proportion of the total costs of regulation."[146] With regard to the compliance cost burden on regulated firms, in principle, firms may gain from having to deal with only one regulator and one set of requirements. This is not guaranteed however, because a single regulator's regime might prove to be more burdensome than the combined weight of the applicable parts of a fragmented regime.

The FSA is funded entirely by industry levy.[147] With that in mind, it is unsurprising that the likely efficiency of the new regime was a major concern for industry participants in the pe-

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ET AL., INTERNATIONAL MONETARY FUND: UNITED KINGDOM EXPERIENCE (IMF Staff Country Report No. 99/44, 1999).

142. JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶ 103.

143. *Id.*

144. GOODHART ET AL., *supra* note 12, at 151–52.

145. For a summary, see GOODHART ET AL., *supra* note 12, at 152–55. *See also* Mwenda & Fleming, *supra* note 1, at 3, 11.

146. GOODHART ET AL., *supra* note 12, at 152.

147. Financial Services and Markets Act, 2000, c. 8, § 12(6) (Eng.).

riod leading up the passing of FSMA. Politically, these were concerns that needed to be explicitly addressed in order to retain industry confidence. Accordingly, clear provisions relating to efficiency were built into the legislative framework.[148] In discharging its general functions, the FSA must have regard to a series of statutory regulatory principles, the first-listed of which is "the need to use its resources in the most efficient and economic way."[149] Another of these principles is that burdens imposed must be "proportionate to the benefits . . . which are expected to result from the imposition."[150] This "proportionality principle" provides a measure against which the FSA must judge whether the costs of regulatory compliance that it imposes on an industry are justifiable.[151] It is supplemented by specific procedural obligations on the FSA to do, and to publish, cost-benefit analysis as part of the process of consultation before it exercises certain of its lawmaking powers.[152] The legal obligation of the FSA to be mindful of the need to run an efficient and economic regulatory regime is further reinforced by other statutory regulatory principles that require it to consider, first, "the international character" of the financial industry and the desirability of maintaining the U.K.'s competitive position and, second, "the need to minimize the adverse effects [of its activities] on competition."[153]

The FSMA gives the government power to commission and publish independent value for money audits of the FSA.[154] However, calls for the National Audit Office to have a direct

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148. *Id.* § 2(2)–(3).

149. *Id.* § 2(3)(a).

150. *Id.* § 2(3)(c).

151. *Id.* § 4(2)(a).

152. In particular, its general rulemaking powers under Financial Services and Markets Act, 2000, c. 8, § 155(1)(2)(a) (Eng.). Whether meaningful cost benefit analysis can actually be achieved by the FSA is an issue that divides commentators. *Compare* ISAAC ALFON & PETER ANDREWS, COST-BENEFIT ANALYSIS IN FINANCIAL REGULATION — HOW TO DO IT AND HOW IT ADDS VALUE (FSA Occasional Paper No. 3, 1999), *with* Charles A. E. Goodhart, *Regulating the Regulator — An Economist's Perspective on Accountability and Control, in* REGULATING IN THE TWENTY-FIRST CENTURY, *supra* note 48, at 151, 156–57. *See also* DAVID SIMPSON ET AL., SOME COST BENEFIT ISSUES IN FINANCIAL REGULATION (FSA Occasional Paper No. 12, 2000), *available at* http://www.fsa.gov.uk/pubs/policy/op12.pdf.

153. Financial Services and Markets Act, 2000, c. 8, § 2(3)(e)–(f) (Eng.).

154. *Id.* § 12.

role in relation to the FSA were resisted.[155] As a company, the FSA is subject to requirements of the companies' legislation with regard to the publication of its annual report and accounts.[156] In addition, under the FSMA it must further make an annual report to the Treasury.[157]

To date, how is the FSA's performance measuring up on efficiency and broader economic grounds? The risk-based approach to regulation is the core of the FSA's strategy for achieving regulatory efficiency. The Chairman of the FSA has claimed that: "It has already led to some significant shifts of resources within the Authority, and to a change of emphasis in line supervisory divisions, towards pro-active work intended to head off emerging risks, and away from routine, box-checking exercises focused on mechanical compliance with rule-based requirements."[158]

The allocation of additional resources to upgrade insurance regulation is the most obvious shift that has taken place. This extra allocation has been achieved by diverting resources out of banking supervision on the basis that banking business appears to pose far fewer risks than insurance business.[159] This approach to the allocation of resources does raise the specter of the FSA being prone to shifting its resources around in response to short-term political pressures — insurance is certainly the obvious current weak link in the regulatory framework but it was not that long ago when banking regulation was in the spotlight as the problem area in the aftermath of various bank failures. However, only time will tell whether this is a real problem.

To date, the FSA has done a reasonable job in keeping its own costs under control. According to an FSA comparative study of the direct costs of regulation, the U.K. ranked second most inexpensive, behind Sweden (another single regulator country), with United States ("U.S.") regulatory costs being some eight-

155. JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶¶ 108–11.

156. Financial Services and Markets Act, 2000, c. 8, §§ 10(1), 13, sched. 1 (Eng.).

157. *Id.* § 10.

158. Davies, *Law and Regulation*, *supra* note 91, at 172.

159. FINANCIAL SERVICES AUTHORITY, PLAN AND BUDGET 2002/2003, at 5 (2002), *available at* http://www.fsa.gov.uk/pubs/plan/pb2002_03.pdf [hereinafter PLAN AND BUDGET 2002/03].

een times greater than those in the U.K.[160] However, there are concerns that the FSA has only achieved this position at the expense of regulated firms, which have faced a sharp increase in compliance costs,[161] while the brunt of increased compliance costs have been borne disproportionately by smaller firms.[162] Addressing the issue of compliance costs, FSA Chairman Howard Davies has spoken of the aim of the new regime as being to "reduce the overall costs of regulation, especially for well-managed firms."[163] While an increase in compliance costs as industry adapted to the new regime was only to be expected, in the longer term, if the position falls far short of Davies' aim, this would be a major source of industry dissatisfaction. At worst, it could result in firms engaging in "regulatory arbitrage" and shifting their regulatory base to a lower cost jurisdiction.[164] If that were to happen, the FSA would have difficulty convincing observers that it has properly observed the statutory regulatory principles on competitiveness within an international market to which it is supposed to have regard.

Studies on whether the FSA has realized its potential in deploying human resources more efficiently may be forthcoming. Presently, the main concern relating to the FSA's human resources is whether it can attract, and retain in overall terms, a sufficient number of well-qualified staff because of the large

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160. Howard Davies, N2 Plus 3, Speech at the Worshipful Company of Chartered Secretaries & Administrators Annual Lecture (Mar. 5, 2002), *available at* http://www.fsa.gov.uk/pubs/speeches/sp93.html [hereinafter Davies, N2 Plus 3]. For further analysis, see FSA, ANNUAL REPORT app. 10 at 133–38 (2001/2002), *available at* http://www.fsa.gov.uk/pubs/annual/ar01_02.pdf; FSA, ANNUAL REPORT app. 5 at 79–83 (2000/2001), *available at* http://www.fsa.gov.uk/pubs/annual/ar00_01.pdf.

161. Using the definition of compliance costs offered by ALFON & ANDREWS, *supra* note 152, at 16, as being: the costs to firms and individuals of those activities required by regulators that would not have been undertaken in the absence of regulation. Davies notes that extensive comparative data on the total costs of regulation is not available and that such data as exists is somewhat impressionistic. Davies, N2 Plus 3, *supra* note 160. *See also* Graham Bannock, *Financial Services Regulation: Controlling the Costs,* 6 FIN. REG. 31, 32–33 (2002).

162. DAVID LASCELLES, CENTRE FOR THE STUDY OF FINANCIAL INNOVATIONS, HOW THE CITY VIEWS ITS NEW REGULATOR 17–19 (2001); Michael Becket, *FSA Red Tape "Hits Small Businesses,"* DAILY TELEGRAPH (London), May 18, 2001, at 34.

163. PLAN AND BUDGET 2002/03, *supra* note 159.

164. JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶¶ 52–53.

disparity in pay levels between the private and public sectors.[165] Although the FSA has attracted some leading figures from the professions into top-level positions,[166] this is not necessarily indicative of success at all levels within its staffing structure. Senior people who have already fulfilled many of their career ambitions within the private sector are likely already to have achieved a level of financial security that allows them to consider a lifestyle change and/or enables them to appreciate the opportunity to contribute to policy development in areas with strong public interest implications.[167] Young, ambitious, and skilled lawyers, accountants, economists, and other professionals who would be suited to careers in regulation, however, may not (yet) have the luxury of financial security. Furthermore, from their perspective, there is a particular disadvantage that flows directly from the streamlined, unified structure of a single regulator. Put simply, if the management system is unified then there are fewer top positions to which they can aspire. On the other hand, it may be argued that this narrowing of opportunity at the very top is counter-balanced by the greater power, influence, and prestige that should attach to senior positions below the very top level in an agency that is responsible for regulating an entire industry, than to positions of an equivalent level within a fragmented regulatory structure. The impact of the narrowing of career opportunities that may result from the adoption of the single regulator model, and the possible counterbalancing effect of the enhancement in the quality of certain positions just below the very top level, are issues that, to date,

165. This was a concern for the Joint Committee. *Id.* ¶¶ 249–53. There continue to be newspaper reports about the FSA's difficulties in retaining staff. *See, e.g.,* Chris Hughes, *FSA Aims to Stem Staff Exodus with 7.4% Pay Rise,* INDEP., Feb. 1, 2002, at 21.

166. In particular, the FSA has recruited a small team of senior executives recently retired from banks and insurance companies (the "grey panthers") to keep in touch with the markets and advise the FSA staff on transactions. Katherine Griffiths, *FSA "Grey Panthers" to Hunt for Failures*, INDEP., Dec. 4, 2001, at 17.

167. For example, John Tiner, now a managing director at the FSA, was recruited from the private sector (Arthur Andersen) in 2001 with a reported drop of £750,000 in salary. Tiner has been quoted as explaining his switch on the grounds that it gave him the opportunity to help shape a national industry: "I've always known I would go into public service." William Kay, *The Head of the FSA is a Man with a Mission to Succeed. But at What*?, INDEP., May 25, 2002, at 2.

have attracted little attention but they may merit closer examination.

Spending time at the FSA at an early stage in one's career might be attractive to young, skilled professionals if that were to be seen as an especially good route into a lucrative career in the private sector. Although the practice of people building careers in the financial industry in this way is not as well-established in the U.K. as it is assumed to be in the U.S.,[168] there are growing indications of FSA experience being used as a springboard from which to launch a more lucrative private sector career.[169] Therefore, there may be an increasing trend towards this pattern of career development. Such a trend could benefit the FSA because it could increase the size and quality of the human resources available to it. However, there are also potential drawbacks in that it could encourage industry capture because junior regulators might be tempted to adopt lax practices with regard to the firms for which they are responsible in order to enhance their own career opportunities. High turnover of junior-level FSA staff could also prove costly for regulated firms since they would, in effect, have to absorb costs involved in dealing with inexperienced and untested regulators.

Generally speaking, although still a nascent organization, the FSA regime does not show signs of having been captured by industry. Criticisms from industry that the FSA is too consumer-orientated[170] and criticisms from consumer groups that the FSA is too pro-industry, [171] largely balance each other out, which overall, might be thought to be a reasonable state of affairs.[172] The FSA regime has broadly retained the confidence of both industry and consumer associations. Its success in this respect is widely attributed to the FSA's first Chairman, How-

168. JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶ 252.

169. *See* Hughes, *supra* note 165.

170. For example, Mary Francis, Director-General of the Association of British Insurers, has been quoted as describing the FSA as "the provisional wing of the Consumers' Association." Liam Halligan, *The FSA Must Put Its Own House in Order,* SUNDAY TELEGRAPH, July 29, 2001, at 4.

171. Particularly with regard to its stance on endowment mortgages and the for profits industry more generally. *See supra* notes 134–37.

172. *See, e.g.*, Chris Hughes, *Three Years On, the FSA Finds Itself Under Attack From All Sides*, INDEP., July 20, 2001, at 21.

ard Davies, who is thought to have had a benign influence on the character of the new regime.[173]

C. The Single Regulator Model May Provide a More Effective System of Regulation

Effectiveness is measured by whether a regulatory system achieves its objectives.[174] Effectiveness overlaps with suitability — a single regulator may be more effective than alternative regulatory models because its structure is better suited to the increasingly integrated nature of financial markets. Employing current popular jargon, the single regulator is likely to be effective because it has a full regulatory "toolkit" at its disposal and is thus ideally placed to select the optimal regulatory responses to any situation.[175] Effectiveness also overlaps with efficiency because inefficient regulation is likely to produce results that are inimical to a properly effective system of regulation.

An argument that merits separate attention is that a single regulator may be more effective because of the coherence and clarity of its mandate. Lack of coherence and clarity about what an agency is supposed to do would be a major weakness of any regulatory system, whether it involves a single regulator or several agencies.[176] But a particular argument for the superiority of the single regulator model in this respect is that the single regulator may be ideally positioned to maintain coherence and clarity of purpose because its unified management structure provides an effective mechanism for resolution of conflicts between different regulatory objectives.[177] However, commentators are sharply divided on this alleged benefit. Charles Goodhart and his co-authors suggest that a single regulator may lack

173. George Trefgarne, *When the FSA Pulls the Strings . . . There is a Refuge from Sir Howard Davies's Red Tape,* DAILY TELEGRAPH, Dec. 1, 2001, at 35.

174. JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶ 103.

175. NEW REGULATOR FOR A NEW MILLENNIUM, *supra* note 122, at 25–32 (Chapter 3 outlines the FSA's regulatory tools and considers how they may be used in practice).

176. Alan Page, *Regulating the Regulator — A Lawyer's Perspective on Accountability and Control, in* REGULATING IN THE TWENTY-FIRST CENTURY, *supra* note 48, at 127.

177. BRIAULT, THE RATIONALE, *supra* note 8, at 7, 21.

"a clear focus on the objectives and rationale of regulation."[178] So instead of facilitating coherence and clarity, the single regulator model may result in self-contradiction and confusion. Michael Taylor argues that, rather than being a benefit, the ability of a single regulator to resolve disputes about objectives internally is an undesirable feature because such disputes should be resolved at the political level due to their public policy implications.[179] Alternative regulatory models have been put forward by these authors, in which regulatory responsibilities are divided between agencies by reference to different regulatory objectives.[180]

Another theoretical argument for the greater effectiveness of the single regulator model is with regard to consistency, communication, and cooperation at operational levels.[181] Individual regulators may find it easier to communicate and cooperate with each other on matters of common concern when they all work for the same organization rather than when they are scattered between different agencies. Moreover, they should all have a shared cultural approach to their task and operate consistently in accordance with the common policies set at management level.[182] However, success is not guaranteed. Whether these potential gains are realized is obviously dependent on how well separate, specialized divisions within the single regulator actually do cooperate and communicate with each other, and how effectively a consistent cultural approach has permeated throughout the organization.[183]

Law can play a key role in providing a clear and authoritative statement of objectives and in providing an agency with powers to enable it to operate in a consistent manner. The value of establishing a legal framework specifically designed to support the effectiveness of the single regulator model was recognized in the U.K. The "easy" option of simply piecing together the existing sectorally-based legal regimes and vesting all of those exist-

178. GOODHART ET AL., *supra* note 12, at 153. *See also* DANIEL GROS & KAREL LANNOO, THE EURO CAPITAL MARKET 146–47 (1999) (arguing that regulation by objective could result in excessive regulation of wholesale business because of misplaced concerns about consumer protection).

179. TAYLOR, TWIN PEAKS, *supra* note 117.

180. GOODHART ET AL., *supra* note 12, at 156.

181. *See* BRIAULT, THE RATIONALE, *supra* note 8, at 17–19

182. *Id.*

183. GROS & LANNOO, *supra* note 178, at 145.

ing powers in the FSA was ruled out in favor of the much more ambitious approach of providing a fully integrated common legal framework.[184] Thus, the FSMA gives the FSA broad powers to regulate across the financial sector. The Act also deepens the regulatory regime in key respects including, in particular and most controversially, a new market abuse regime that allows the FSA to impose civil penalties on any person — not just those within the regulated financial industry — who has engaged in abusive conduct.[185]

The cornerstone of the FSMA is the statement of regulatory objectives, which are: maintaining confidence in the financial system; promoting public understanding of the financial system; securing the appropriate degree of protection for consumers; and reducing financial crime.[186] The FSA is under a statutory duty in discharging its general functions to act in a way that is compatible with the regulatory objectives, but only so far as is "reasonably possible."[187] Subject to the same qualification, in the discharge of its general functions the FSA is also required to act in a way that it "considers most appropriate for the purpose of meeting those objectives."[188] These duties are supplemented by the obligation to consider specified regulatory principles, as previously discussed.[189]

The inclusion of a statement of regulatory objectives in the FSMA was generally welcomed during the passage of the legislation, although there was, inevitably, some discussion about whether the right objectives had been specified[190] as well as a more technical legal debate about the drafting of the relevant provisions.[191] The statutory statement of objectives represents a brave attempt to distill the purposes of regulation across sec-

184. Prior to December 2001, the overhaul was not so radical at the second-tier level (i.e., in the rules made by the FSA itself). There, the emphasis was on changes necessary to achieve consistency and simplification, rather than on re-assessment of fundamental principles. Davies, *Law and Regulation*, *supra* note 91, at 169.

185. Financial Services and Markets Act, 2000, c. 8, pt. VIII (Eng.).

186. *Id.* at pt. I, §§ 3–6.

187. *Id.* at pt. I, § 2.

188. *Id.*

189. *See supra* notes 149–53 and accompanying text.

190. In particular whether there should have been a further objective, also requiring the FSA to promote competition.

191. *See* JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶¶ 18–62 (providing a helpful summary of the main aspects of the debate).

tors that traditionally may have had different focuses.[192] But whether this statement, supplemented by the regulatory principles, actually gives the FSA a clear idea of its purpose and provides it with a workable basis on which to build a coherent and consistent system of effective financial regulation, are major questions that will be best examined through the lens of practical experience. At this stage it would seem sensible to have low expectations — the breadth of the objectives and the FSA's wide discretion with regard to their implementation, may mean that the objectives will prove to have limited value in pinpointing exactly what it is that the FSA is supposed to do and, accordingly, whether it has achieved its mandate.

A key set of issues will be those relating to the objective of maintaining confidence in the financial system and how the FSA's role in this respect relates to the Bank's continuing responsibility for the overall stability of the financial system, especially the stability of the monetary and payment financial systems.[193] Will this arrangement prove to be robust in dealing with systemic risks or will the U.K. model validate those who argue that the ability of a central bank to perform its role as overseer of the financial system is undermined if it is not also the regulator of banks and other institutions that present systemic concerns?[194] For now, these are largely questions for the

192. Jackson, *supra* note 123, at 339–63 (Pt. III explores cross-sectoral variation in U.S. financial regulation).

193. A memorandum of understanding between the FSA, the Bank of England and HM Treasury sets out their respective obligations with regard to financial regulation, details arrangements for Bank of England access to FSA supervisory records and sets outs procedures, in the form of monthly meetings, for cooperation between them. *See* Memorandum of Understanding Between HM Treasury, the Bank of England and the FSA (Oct. 28, 1997), *available at* http://www.hm-treasury.gov.uk/Documents/Financial_Services/Regulating_Financial_Services/fin_rfs_mou.cfm.

194. *See* EUROPEAN CENTRAL BANK, THE ROLE OF CENTRAL BANKS IN PRUDENTIAL SUPERVISION 7 (2001), *available at* http://www.ecb.int/pub/pdf/prudentialsupcbrole_en.pdf [hereinafter ECB, THE ROLE OF CENTRAL BANKS] (providing a recent restatement of the case for preservation of a fundamental role in prudential supervision for national central banks, with particular reference to the eurosystem). *See generally* Leonardo Bartolini, *The Financial Services Authority: Structure, Mandate and Policy Issues, in* HOSSEIN SAMIEI ET AL., INTERNATIONAL MONETARY FUND: UNITED KINGDOM EXPERIENCE (IMF Staff Country Report No. 99/44, 1999); GROS & LANNOO, *supra* note 178, at 140–43.

future,[195] but it is interesting to note that some of those within the U.K.'s financial industry who welcomed the original concept of the single regulator in the U.K. are now beginning to revisit the issue precisely because of concerns about the allocation of responsibilities between the Bank and the FSA.[196] The merits of the U.K. approach with regard to the allocation of responsibilities for financial stability have also been doubted by the European Central Bank.[197]

The FSA has made an inauspicious start concerning claims about the superiority of the single regulator model on the grounds of greater consistency in institutional approach and shorter and simpler lines of communication and cooperation between individual regulators. An FSA internal report on its handling of the crisis affecting a major insurance company in 1999 and 2000 specifically identified poor communication between regulators working within different departments of the FSA as a deficiency in regulation.[198] To date, this remains the most prominent and embarrassing example of the FSA failing to live up to its potential as an effective single regulator; however, there have been others. A more recent example is the criticism by influential bodies within the banking sector of the FSA's proposed prudential rules that, in their view, showed all

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195. BRIAULT, REVISITING THE RATIONALE, *supra* note 141, at 14–15, 27–31 (considering the practical operation of this arrangement). Briault suggests that the tripartite arrangement between the Bank, the FSA, and the Treasury works well, although he acknowledges that "the arrangements have not yet been put to the test in a period of massive financial instability, or of the 'failure' of a firm (or firms) posing a significant systemic risk." *Id.* at 15. Others are more skeptical: "The memorandum created the impression they were working together fine, but there's still competition and jealousy of each other's turf. The Bank still considers itself to have some residual authority over the FSA." Faisal Islam, *One of our Governors is Missing: But is the Treasury Looking in the Wrong Place to Fill the Bank of England Job?*, OBSERVER, Sept. 1, 2002, at 5 (quoting Kern Alexander, Senior Fellow in International Law at the Judge Institute, Cambridge).

196. Views of Ian Mullen, Chief Executive of the British Bankers' Association ("BBA"), as reported in *BBA's Unhelpful Criticism Of Financial Services Authority — A Recent Speech By The Head of the British Bankers' Association, In Which He Lambasted The UK's Financial Services Authority, Is Unfair On The Super-regulator*, BANKER, June 1, 2002.

197. *See generally* EUROPEAN CENTRAL BANK, THE ROLE OF CENTRAL BANKS IN PRUDENTIAL SUPERVISION (2001), *available at* http://www.ecb.int/pub/pdf/prudentialsupcbrole_en.pdf.

198. BAIRD REPORT, *supra* note 135, ¶ 6.2.5.

the signs of having been drafted by specialist teams with no one taking overall responsibility to ensure a coherent and consistent approach.[199] In the short term, the FSA can use its youthful status and inexperience as a single regulator as an excuse for this type of regulatory shortcoming, but explanations of that sort will become less convincing as the regime matures.

D. A Single Regulator May be More/Less Accountable

In its simplest terms, the argument for a single regulator case on accountability grounds is that a single regulator has no other regulatory body to which it can transfer blame for regulatory failure.[200] It is suggested that the fact that "the buck stops here" provides the regulator with a strong incentive to establish a clear mandate, to stick to it in its practical operations, and to educate consumers of financial services on what protections they can and cannot reasonably expect from the regulatory system.[201] These features are connected with accountability because the more clearly the regulator's mandate and areas of responsibility are defined, the easier it should be for those who are affected by its operations to hold it accountable.[202] However, commentators also identify major concerns about accountability in relation to single regulators because of the all-embracing nature of their role and their concentrated and potentially draconian powers.[203] Can a single regulator be made properly accountable to an industry while avoiding regulatory capture? Can it be made properly accountable to consumers without creating false perceptions and possible moral hazard concerns about the extent to which the regulatory system will protect them from financial risks? If the single regulator is independent of government, as is the case in the U.K., by what mechanisms can it be held politically accountable in respect of

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199. *See* Press Release, British Bankers' Ass'n, BBA/LIBA Response to Consultation Paper 97 — The Integrated Prudential Sourcebook (Jan. 17, 2002), *available at* http://www.bba.org.uk/public/newsroom/35451/42733/45188?version=1.

200. GOODHART ET AL., *supra* note 12, at 152; Chris Hughes, *The Buck Stops Here*, INDEP., Oct. 3, 2001, at 1.

201. GOODHART ET AL, *supra* note 12, at 151–52

202. LARGE, *supra* note 50, at 82; JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶¶ 99–146; ROBERT BALDWIN & MARTIN CAVE, UNDERSTANDING REGULATION: THEORY, STRATEGY, PRACTICE ch. 21 (1999).

203. GOODHART ET AL., *supra* note 12, at 153–54.

its public interest functions? These questions are much debated in the literature on regulation and the arguments are often finely balanced. They were also major preoccupations in the public debate in the U.K. leading up to the adoption of the single regulator model.

Industry lobbying groups made extensive use of a nightmarish vision of the FSA as an over-mighty, over-powerful bully in their efforts to influence the content of the legislative framework from which it would derive its powers.[204] Particularly, in relation to its disciplinary and enforcement powers, lurid images of the FSA as legislator, prosecutor, judge, jury, and executioner all rolled into one were frequently invoked.[205] The FSMA, as finally enacted, does give the FSA very extensive powers, but there are also broad legislative control mechanisms which are intended to act as checks and balances against the FSA in the use of these powers.

The regulatory objectives and principles lie at the core of the accountability mechanisms. They are relevant to public accountability (i.e. accountability to industry and consumers), political accountability, and judicial accountability since they provide all interested parties with benchmarks against which to judge the FSA's performance. While the statutory statement of objectives and principles is broadly welcome as an improvement to the accountability framework, some of the more optimistic statements about the significance of the objectives and principles need to be viewed with care. For example, it has been suggested that the regulatory objectives and principles provide the basis for legal accountability because "the FSA could be challenged in the courts on the grounds that it has failed to pursue its objectives or to take the principles into account."[206] While this statement is certainly true, cases where legal challenges against the FSA on these grounds actually succeed are likely to be rare. This is because the FSMA gives the FSA considerable discretion as to how best to meet its objectives. Its duty to act in a way that is compatible with the objectives and, for the purpose of meeting them, extends only "so far as is reasonably pos-

204. *See* Gary Parkinson, *FSA Bows to Criticisms of Being Judge and Jury in Enforcement Regime*, MONEY MARKETING, July 8, 1999, at 2.

205. Dan Atkinson, *"Judge, Jury and Executioner" Claims Defeat City Super-regulator*, GUARDIAN, July 6, 1999, at 22; Parkinson, *supra* note 204, at 2.

206. BRIAULT, REVISITING THE RATIONALE, *supra* note 141, at 12.

sible."[207] It is for the FSA itself to decide on the "most appropriate" way in which to meet the objectives.[208] Further, the obligations of the FSA with regard to the objectives only arise in relation to its "general functions" — its functions in making rules, issuing codes, and giving general guidance *considered as a whole* and its function of determining general policy and principles.[209] Similarly, the FSA is only required to "have regard" to the regulatory principles and, as with the objectives, this duty only arises in relation to the discharge of its general functions.[210] This careful drafting ensures that there is no mechanism for challenging individual rules or decisions on the grounds that they are incompatible with the objectives or principles. The qualified and self-referential nature of the duties regarding the regulatory objectives and principles appears likely to hamper the effectiveness of judicial review in practice.

Similar caution is appropriate at this stage in relation to other, more detailed, accountability mechanisms provided for in relation to the FSA because they have only been fully operative for a short period of time. Some important aspects are largely untested. For example the Financial Services and Markets Tribunal ("Tribunal"), which is an independent review body to which certain FSA decisions can be referred, has not yet heard a case through to completion. The provisions for the Tribunal in the legislative framework[211] are intended to assuage concerns about the all-embracing role of the FSA as judge, jury, etc, and to meet human rights-related concerns about the availability of independent, fair trials.[212] It has been envisaged that over time this Tribunal will play a key role in relation to FSA accountability.[213] However, the public nature of the Tribunal proceedings may in practice deter people from challenging FSA decisions via this route because of fears about adverse reputational consequences, even if the challenge is successful.

207. Financial Services and Markets Act, 2000, c. 8, § 2 (Eng.).

208. *Id.* § 2(1)(b).

209. *Id.* § 2(4).

210. *Id.* § 2(3)–(4).

211. *Id.* pt. IX.

212. Thomas A. Beazley, *Holding the Balance — Effective Enforcement, Procedural Fairness and Human Rights, in* REGULATING IN THE TWENTY-FIRST CENTURY, *supra* note 48, at 115–26.

213. FRESHFIELDS BRUCKHAUS DERINGER, FINANCIAL SERVICES: INVESTIGATIONS AND ENFORCEMENT 255 (2001). [hereinafter FRESHFIELDS].

The FSA Chairman has claimed that the "prime accountability route" for the FSA will be through Ministers to Parliament,[214] but some commentators have doubted how effective political accountability will be in relation to the FSA.[215] The FSA is an unusual hybrid. It is a private company limited by guarantee and its operations are funded entirely by industry levy.[216] However, the government exercises control in that the Treasury appoints the FSA board,[217] can order independent reviews of its financial affairs,[218] and can commission independent inquiries into regulatory failures.[219] The Treasury, however, cannot intervene directly in the affairs of the FSA, save in very limited circumstances concerned with competition policy.[220] The FSA must make an annual report to the Treasury.[221] The Treasury must put the FSA's report before Parliament.[222] FSA officials can also be ordered to appear before a parliamentary select committee in accordance with the usual procedures of the Houses of Parliament.[223] In practice, the Treasury Select Committee routinely takes evidence from the FSA twice a year, once on its plan and budget for the coming year, and once on its annual report for the previous year. It can also hold inquiries from time to time as it sees fit.[224] Views on whether the system of appearing before the Treasury Select Committee is likely to prove an effective form of accountability to Parliament, are mixed. Although the IMF considers that appearances by financial agency officials before a designated public authority — such as a parliamentary committee — promote accountability, especially when the agencies are granted a high degree of auton-

214. JOINT COMMITTEE FIRST REPORT, *supra* note 84, at Minutes of Evidence ¶ 2 (question 2, reply by Davies, Chairman FSA).
215. *See, e.g.,* Page, *supra* note 176, at 132–33.
216. Financial Services and Markets Act, 2000, c. 8, §§ 13–14, 17 (Eng.).
217. *Id.* § 1.
218. *Id.* § 12.
219. *Id.* § 14.
220. *Id.* § 308.
221. *Id.* sched. 1, § 10. The Treasury can direct the FSA with regard to the contents of the report.
222. *Id.* § 10(3).
223. *Id.* §§ 4–5.
224. *Id.* § 14.

omy,[225] others doubt this.[226] So far, the evidence indicates that appearing before the Treasury Select Committee can be a very uncomfortable short-term experience for FSA officials.[227] But long-term studies will be needed to establish whether this process has meaningful impact.

With regard to public accountability, the FSMA provides for a variety of consultation and disclosure requirements. The FSA is required to engage in public consultations before exercising rulemaking powers, including publication of rules in draft form accompanied by cost-benefit analysis.[228] The FSA has a general obligation to establish and maintain arrangements for consultation with consumers and practitioners.[229] This gives statutory backing to the arrangements that had previously operated in practice, whereby the FSA consulted with a Consumer Panel and a Practitioner Panel.[230] The FSA must have regard to any representations made by either of the panels and, if it disagrees, it must give a written statement of its reasons for doing so.[231]

Again, it is too early to test how well these requirements are working. There are some indications of dissatisfaction with the practical operation of the public consultation requirements,

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225. INTERNATIONAL MONETARY FUND, CODE OF GOOD PRACTICES ON TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES: DECLARATION OF PRINCIPLES 13 (Sept. 1999), *available at* http://www.imf.org/external/np/mae/mft/code/eng/code2e.pdf.

226. Page, *supra* note 176, at 134–35.

227. As this selection of headlines from the press coverage of Davies' appearances before the Select Committee with regard to the Equitable Life crisis illustrates. Katherine Griffiths, *MPs Attack Davies Over Equitable Life Crisis,* INDEP., Oct. 31, 2001, at 17; Nina Montagu-Smith, *FSA Role Puzzles Equitable Inquiry*, DAILY TELEGRAPH, Nov. 14, 2001, at 36; *FSA Denies Collusion with Equitable*, INDEP., Nov. 14, 2001, at 21; *Davies to Face Second Grilling,* DAILY TELEGRAPH, Nov. 12, 2001, at 28.

228. Financial Services and Markets Act, 2000, c. 8, § 65 (Eng.) (guidelines for drafting statements or codes that the Authority may issue describing conduct expected of approved persons); *id.* § 121 (guidelines for drafting codes that the Authority must issue to give guidance for determining whether behavior amounts to market abuse); *id.* § 155 (guidelines for drafting rules under the Authority's general rule-making powers).

229. *Id.* §§ 8–9.

230. *See id.* §§ 9(1), 10(1); Press Release, FSA, Practitioner and Consumer Panels Go Statutory (June 18, 2001), *available at* http://www.fsa.gov.uk/pubs/press/2001/073.html.

231. Financial Services and Markets Act, 2000, c.8, § 11 (Eng.).

largely because of the sheer bulk of consultation material that the FSA has issued in the past few years, and the resources that have gone into responding to it.[232] Given the ambitious nature of the single regulator project in the U.K., it is hard to see how a large and costly consultation process could have been avoided, though it undoubtedly did generate "consultation fatigue."[233] However, if discontent about the burdens on industry and consumers, which are associated with the consultation requirements, does not diminish as the regime becomes more established, this could indicate a serious flaw within the system. The system will also have failed if the FSA develops a reputation for not listening to the criticisms expressed by those who respond to consultation exercises. The FSA will always be vulnerable to this charge, but time and experience will help to distinguish well-founded claims from exaggerated claims made to garner media attention for the self-interested views of a particular group or sector.[234]

Is the independence of the practitioner and consumer panels liable to be compromised because of their position within the formal institutional framework? To be sure, these panels are established by the FSA, the FSA board appoints the members, and it also funds their operation.[235] Moreover, the Consumer Panel, which operates more formally and publicly than the Practitioner Panel, is dependent on FSA staff for its secre-

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232. Jill Treanor *FSA "Less Effective" Than Predecessors* GUARDIAN (London), Nov. 29, 2002, at 30; BBC News, *FSA World's "Most Accountable Regulator"* (Dec. 3, 2002), *at* http://news.bbc.co.uk/1/hi/business/2539001.stm.

233. INQUIRY INTO THE FINANCIAL SERVICES ASSOCIATION'S PRACTITIONER PANEL BEFORE THE SELECT COMMITTEE ON TREASURY (2002), *at* http://www.parliament.the-stationery-office.co.uk/pa/cm200102/cmselect/cmtreasy/600/2020503.htm (statement of Donald Brydon, Chairman of the Practitioner Panel & Chairman and Chief Executive of AXA Investment Managers) [hereinafter INQUIRY INTO THE FSA'S PRACTITIONER PANEL].

234. CSFI, WAKING UP TO THE FSA, *supra* note 128, at 13 (noting complaints from industry participants that their comments have been ignored by the FSA but suggests that this criticism is not altogether fair). The Consumers Association has also accused the FSA of failing to listen to objections about FSA proposals for new rules on the way financial products are sold to investors. Teresa Hunter, *Consumer Group Savages FSA Plans: CA Says Adviser Reforms will be Confusing and Add to Costs,* SUNDAY TELEGRAPH, Apr. 28, 2002, at 4; William Kay, *Consumers Rip into FSA Proposals*, INDEP., Apr. 27, 2002, at 1.

235. Financial Services and Markets Act, 2000, c. 8, § 1(9)–(10) (Eng.).

tariat.[236] All of these features suggest that the panels may struggle to achieve and maintain independence.[237] A report in *The Observer* on the Consumer Panel's annual report encapsulates the issue neatly with the comment: "Brown [chair of the Consumer Panel] remains confident and hopeful that the FSA can clean up the financial services industry. His own job depends on it, after all."[238] The counterargument is that the close links should facilitate constructive and better-informed dialogue between the FSA and the panels. The structure is, then, best viewed as a compromise between true arms-length independence, and privileged access to FSA information and personnel. Whether the optimal trade-offs have been made will be a question for future study.

V. A CONCLUSION AND SOME OBSERVATIONS

The U.K. embraced the single regulator concept in an ambitious way. It decided to bring many different regulatory agencies together into one single institution. Moreover, it decided to place its single regulator within a new, properly-integrated, legal framework, rather than simply giving it the powers that had been previously enjoyed by former regimes, which were divided by sector through a process of stitching together or consolidating existing legislation. Creating the new integrated legal framework was a massive, complex, and time-consuming exercise. Moreover, it was often highly controversial. But, in the end, it was done[239] and when the new system finally became fully operational, it happened smoothly without disruption to the markets.

Accordingly, one definite conclusion that can be drawn from the U.K. experience is that, if the political will is present, major reform of this type can actually be accomplished and effectuated

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236. *Id.* ¶ 1(10).

237. The Treasury Select Committee has expressed some concerns about the panel's lack of financial independence and the FSA's control over the selection processes. INQUIRY INTO THE FSA'S PRACTITIONER PANEL, *supra* note 233 (Question by Mr. Tyrie, Question 15; Question by Mr. Mudie, Questions 45–48; Question by Mr. Laws, Questions 89–90).

238. Maria Scott, *Cash: Incredible: "This Reckless Greed": Watchdog Attacks Industry Where "Consumer is a Dirty Word,"* OBSERVER, May 19, 2002, at 2.

239. Although details of the new legal regime at the level of the FSA Handbook are still to be overhauled. Davies, *Law and Regulation*, *supra* note 91, at 171–72.

within a mature, major international financial center. The U.K. experience also provides support for the intuitive assessment that political support for change will be greater where the existing system is, or is perceived to be, malfunctioning. Beyond this, it is impossible to draw firm conclusions, because the new regime is still in its infancy. Yet there are certainly many positive signs, in particular, the emphasis on an integrated approach to regulation across all parts of the financial services industry.

One interesting feature of the recent British experience with financial regulation is the extent to which the character of its new regime has been associated with its first Chairman, Howard Davies. It is hard to tell whether, or to what extent, the degree of identification of the new regime with a single individual is related to the unitary structure of the FSA, but there may be a significant connection. Arguments for the adoption of the single regulator model include economies of scale through unified management and staffing, and greater effectiveness through the development of a single, institutionalized approach to regulation. A corollary of these arguments is that managerial power will be concentrated in relatively few individuals. Thus, those at the very top of the structure should be in a particularly strong position to dominate the culture and institution. Questions about governance and structure are particularly important because the single regulator model is characterized by a regulatory regime vulnerable to the personal influence of a few individuals. Whether the FSA should have a separate chairman and chief executive is an issue that was sidestepped in relation to Davies because he was already in office by the time the question became a topic for public debate.[240] However, in a broad sense, the FSMA now requires the FSA to have regard to corporate governance principles.[241] Although the significance of the FSA's status as a company should not be taken too far, principles developed in the corporate sector to avoid the potential adverse effects of domination by one individual could, with suitable adaptation for the regulatory context, be useful as

240. JOINT COMMITTEE FIRST REPORT, *supra* note 84, ¶¶ 112–13.

241. Financial Services and Markets Act, 2000, c. 8, § 7 (Eng.). The duty is to have regard to such principles "as it is reasonable to regard as applicable to it." *Id.*

a way of addressing the potential problem of concentration of influence within the unitary FSA regime.

A potentially worrying sign emanating from the top of the FSA is the continuing enthusiasm for further legal change. Rather than giving its own staff, and everyone else, breathing space in which to work with the new regime, the FSA has declared itself to be a "reforming authority" and has announced "a considerable programme of reform to many parts of our rulebook."[242] This reforming zeal can be defended on the grounds that the process of fundamental legal reform that began in 1997 with the announcement of the proposal to adopt the single regulator model, is still incomplete because the review of the lower-tier rules, i.e. those in the FSA Handbook, that took place in the transitional period, was intended to achieve consistency and simplification rather than to re-think fundamental principles. Furthermore, standing still for a long time is not a sensible strategy in financial regulation because the system needs to evolve if it is not to lag too far behind developments in the market. But, while ossification of the system clearly would be in no-one's interests, the FSA needs to be careful not to act excessively in the pursuit of the goal of integrated regulation.

In the sometimes-fevered debate that surrounded the enactment of the FSMA, the prospect of the FSA using its disciplinary and enforcement powers excessively tended to attract the most attention. Those fears have receded, partly, but not exclusively,[243] because of legal intervention in the form of procedural safeguards and, in particular, the establishment of the Financial Services and Markets Tribunal. At present, there appears to be a reasonable degree of confidence in the robustness of these controls on the FSA's disciplinary powers,[244] although this confidence has not yet been properly tested under the pressure of practical, and perhaps controversial, experience. As a lawmaker, the FSA is subject to looser forms of control, principally in the form of consultation and disclosure requirements, includ-

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242. FINANCIAL SERVICES AUTHORITY, ANNUAL REPORT 5 (2001/2002), *available at* http://www.fsa.gov.uk/pubs/annual/ar01_02.pdf.

243. Changes in personnel at the top of the FSA enforcement division have also been thought to have played a part. In 2001, the head of the FSA's enforcement division was switched to a different position within the organization.

244. *See, e.g.,* FRESHFIELDS, *supra* note 213, at 255.

ing cost-benefit analysis, underpinned by its obligations with regard to statutory regulatory principles and objectives. How effective these controls will be is open to speculation, but it seems unlikely that they would prevent a drift towards a more legalistic and bureaucratic approach if that is the direction in which those in charge of the maturing FSA choose to take it.

But how much freedom will the FSA actually have to shape its own destiny as a rule-maker? A powerful constraint on the FSA's rule-making discretion is its obligation to give effect to EC law.[245] Significant parts of the FSA Handbook already reflect EC rules on banking, insurance, and securities regulation.[246] And the EC influence is increasing as central EC institutions vigorously pursue the goal of full financial integration.[247] There is a trend away from the established approach of minimum harmonization — where the minimum requirements are set at central EC level, but with discretion for member states to impose stricter requirements (sometimes known as "super-equivalence") towards maximum harmonization, where no deviation from the rules set by the central EC authorities is permitted.[248] Current trends suggest that national regulatory authorities of the EC member states will increasingly find their autonomy with regard to rulemaking eroded by obligations to give effect to requirements that have been set at EC level. Their role seems likely to shift from that of direct legislator to that of participant in the process whereby rules are developed at EC level.[249] The goal of ensuring consistency across member

245. Financial Services and Markets Act, 2000, c. 8, §§ 148, 410 (Eng.).

246. *See* FSA HANDBOOK, *available at* http://www.fsa.gov.uk/handbook (last modified Mar. 3, 2003)

247. H. Onno Ruding, Vice Chairman, Citibank, Remarks at the Sixth European Financial Markets Convention in Brussels (May 31, 2002), *available at* http://www.fese.be/initiatives/speeches/2002/efmc2002_ruding_speech.htm.

248. FINANCIAL SERVICES AUTHORITY, REVIEW OF THE LISTING REGIME ¶¶ 3.5–3.25 (July 2002) (discussing European developments and the controversy that the switch towards maximum harmonization has provoked with reference to the ability of national regulatory authorities to impose corporate governance or other qualitative standards beyond those that have been mandated at the European level).

249. Under the Lamfalussy principles national regulators are involved in standard-setting at Level 2 — i.e., filling in the technical details of framework legislation that has been agreed (at Level 1) by the main EC legislative organs. For an overview of the Lamfalussy principles, see Guido Ferrarini, *Pan-*

states would suggest that the EC rules are likely to be increasingly prescriptive with little interpretative discretion or waiver powers being allowed to individual national regulators.[250] So, even though the direct focus of the increasing EC activity is on standard-setting, it seems also likely to affect the day-to-day supervisory relationships between national regulators and regulated firms with regard, for example, to questions of interpretation of particular rules, and/or their application to particular facts, or to applications for rule-waivers in particular circumstances.

Some commentators go further and suggest that the EC is moving inexorably towards the establishment of new pan-European regulatory agencies that would perform the full range of regulatory and supervisory functions, including enforcement.[251] This debate has been particularly active in the securities field where the prospect of a European-Securities and Exchange Commission ("Euro-SEC") is much discussed.[252] It might be said that a shift of regulatory and supervisory powers from national to regional agencies is the logical next stage beyond regulatory consolidation at the national level, as a step in a process that would lead ultimately to the establishment of a single worldwide regulator. Even within Europe, which leads the world in the process of regional financial integration, it seems unlikely in the short-to-medium term that the FSA, or other national regulators, will be replaced by a single Euro-regulator or even (since EC regulation is still largely constructed along sectoral lines) by a group of sectorally-divided Euro-regulators. Banking might look like the most obvious candidate for the assumption of a full regulatory and supervisory role by European institutions but the European Central Bank, which is responsible for monetary policy within the euro

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European Securities Markets: Policy Issues and Regulatory Responses, 3 EUR. BUS. ORG. L. REV. § 2.3 (2002).

250. Level 3 of the Lamfalussy principles aims to encourage cooperation and networking between national regulators to ensure consistent and equivalent application of the rules. The recently-established Committee of European Securities Regulators (CESR) is to play a key role in issuing guidelines, joint interpretative guidance and so forth. *See id.*

251. NIAMH MOLONEY, EC SECURITIES REGULATION 896–97 (Francis G. Jacobs ed., 2002). Chapter 15 provides an admirable summary of the arguments for and against EC centralized regulation and supervision.

252. *Id.* at 843–97.

area, has recently affirmed that the division of responsibilities between itself and national authorities "would seem appropriate to tackle the changes triggered by the introduction of the euro."[253] Public policy debate on fundamental questions about the efficiency, effectiveness, and accountability of super-European regulatory and supervisory agencies is starting but, as yet, it is at an early stage.[254]

However things develop, it seems beyond doubt that in the short-to-medium term, the drive for further regulatory changes affecting the financial sector will come from Europe. It remains to be seen whether the U.K. will be in a strong position to influence change at that level because it has already been through radical upheaval domestically, or whether the U.K. will be found to have made a major strategic mistake by being inward-looking at a time when major reform initiatives were beginning to take shape at the European level. Domestically, although political challenges to the existence of the FSA are always possible, no major political party is likely to espouse the case for further radical, expensive, and disruptive change unless either the FSA fails to deliver the benefits claimed for the single regulator model or that model becomes wholly inappropriate because of changing market conditions. The latter point has particular current relevance because the general economic climate and specific events such as WorldCom and Enron have highlighted the particularly acute conflict of interest problems that can arise within financial supermarkets. These events have added an extra dimension to the debate about the advantages of the "universal banking" business model.[255] "Deconglomeration"

253. ECB, THE ROLE OF CENTRAL BANKS, *supra* note 194, at 7.

254. *See, e.g.,* Chris Bates, *Models for European Regulation: Euro-SEC, Euro-FSA or Lamfalussy?,* 17 J. INT'L BANKING & FIN. LAW 151 (2002); Jeroen Kremers et al., *Does Europe Need a Euro-wide Supervisor?,* 6 FIN. REG. 50 (2001).

255. *Thanks a Bundle — The Model of a Vast, Integrated Financial Firm is Fast Going Out of Favour,* ECONOMIST, Aug. 22, 2002, at 12; Wilmarth, *supra* note 113, at 272–312, 437–44 (discussing disappointing results achieved by banks resulting from big bank mergers). Wilmarth doubts the ability of big, complex financial institutions to produce positive synergies of scale or scope. *Id.* at 438. Further he suggests that arguments used in relation to disenchantment with conglomeration in the industrial sector (e.g., that managers are motivated to build large companies for self interested reasons rather than in pursuit of better returns for investors) are also applicable to the financial sector. *Id.* at 284–85.

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within the financial sector could occur as it did previously in the industrial sector. If firms were to retreat back to the safety of traditional sectorally-divided business, claims about the good "fit" of the single regulator model to the nature of regulated markets and firms would become increasingly hollow.

Time and experience should provide some answers to questions and concerns about the single regulator model that have been raised in this article. The U.K. will now be a valuable source of data on whether, or in what ways, the single regulator model is superior to alternative models of regulation, in terms of suitability, efficiency, effectiveness, and accountability. Practical operation of the new regime will also shed light on the robustness of an ambitious, tailor-made, legislative framework that was designed expressly to help secure the potential benefits of the single regulator model and avoid its possible drawbacks.[256]

256. *See* BRIAULT, REVISITING THE RATIONALE, *supra* note 141, at 11 (identifying the U.K.'s integrated legislative framework as being a particular advantage).

PANEL I (PART 1): DISCUSSION TRANSCRIPT

PROFESSOR BERMAN: Now for our final speaker on the panel, Professor Fanto.

PROFESSOR FANTO: I'm not really a speaker. I'm just a commentator. And being an organizer of the program, I'm acutely aware of the time. So I want to keep the conference on schedule. So I'm just going to offer a few remarks and then maybe a few people from the audience will and our main speakers can respond to them, because I'm trying to slate a break in about ten minutes. So really what I'm going to do is just offer a few comments on really both the papers.

First comment would be, I think both of the speakers emphasized the highly contextual nature of the U.K. change. And I think implicit there is the highly contextual historical nature of financial regulation there and here. And I think that's an important point. We have to keep that in mind from a policymaker's perspective, how we like the change, how much are we unable to change, or what are the real cultural political constraints inhibiting our change. So I think both speakers emphasized that. Dr. Ferran in her paper, she just mentioned it, but it really comes out, the [highly contextual nature].

Nevertheless, countries do change. And I don't think we can be too sanguine about how financial regulation . . . happens to change. I think from a policy point of view we have to realize that it's likely not to happen due to our actions. And I think Dr. Ferran makes that very clear. It's almost fortuitous that the change comes about.

I'm kind of a partisan of more a behavioral approach, which is that change will happen when there's a crisis in the system. Now, maybe she shares that position too. . . . [W]hen she outlines the various problems with U.K. regulation that push the system to the point where people are willing to change, it's the common behavioral position that we all know because we all follow it. We don't really move off the status quo willingly. And we do it reluctantly and only when we're forced to do so.

So I think one of the messages that tell us — we're not really policy makers, but we're people who try to talk to policy makers, as Professor Jackson does — is that you try to wait for the right moment, and if that right moment comes upon you, you offer

your policies. But those moments come. We see it now in the United States with respect to corporate governance. I mean, some people may disagree, well, we don't really need to change. But it's a moment when change is possible and happens.

So that I think is one set of arguments, which is to recognize how you're bound into a position. But it doesn't seem to me that that should keep you from making normative arguments. And it seems to me that in the two papers I found a bit of a reluctance to make a normative argument about, well, in the simple sense, well, what's the best model to have. Again, we have to be careful scholars and recognize that change comes about fortuitously. But nonetheless one might draw some inferences from the data or simply stake out a theoretical position that one model is better than the other or that it seems more convincing.

Now, I think that may be implicit there. I mean, it may be implicit in Professor Jackson's — I mean, he's a careful scholar and if you know his work, he likes to look at a lot of data, both theoretical and empirical, and say, well, look, I'm going through these regulatory costs and I may come to some conclusions down the line. But it seems to me that maybe I'd push them more to stake out a theoretical position. I mean, Dr. Ferran, you're very careful, but one could see one there. One could just look at the U.S. system and . . . take a normative position that systems, despite the goals they try to accomplish, they get so needlessly complex that one feels that you just simply have to rearrange them. And even though you recognize it, it probably can't be done short of a crisis. It seems to me that . . . implicit in Dr. Ferran's talk, there's probably a normative position that having multiple regulators is simply too complex.

Now, I don't know what Howell Jackson . . . feel[s] about that, but maybe you'd want to talk about that. But that's a central comment — and I'm trying to keep this brief for the time — that I have about both papers. So maybe in a minute you would want to talk about that.

Secondly — this you both could talk about too — I think it's very interesting . . . what Professor Jackson has already done in his other work — lay out the regulatory goals and contrast the regulatory goals of the two systems. In reading through that, it seemed to me convincing, even though somewhat surprising. It seems to me sometimes some of those goals — for example, the financial innovation goal [was] certainly a goal for the FSA but was a prominent goal for Gramm-Leach-Bliley as well.

So to talk about financial innovation as being peculiar to the U.K. — and I don't mean to overstate your position or to push the position of the city — I think we could say the same thing here, the concern of the Congress and the federal regulators when they were pushing Gramm-Leach-Bliley is something of the same sort. So sometimes although you could get a different order of priority, it may well be that all the goals really are there.

The one that I found curious is this — and you might find that interesting, too — is . . . our emphasis on redistribution, consumer protection sort of thing. When you think of Community Reinvestment Act, you started by talking about how it's so odd that those economists at Harvard lumped together the U.S. and the U.K., even though U.S. and U.K. are very different. But then — and maybe I'm stating it too strongly — then when you say we have this emphasis on banking regulation, on redistribution and the U.K. at least doesn't, at least not nominally, or less so, I don't know. It just strikes me as curious because it would seem to me that on some of the data from *The Economist* they would suggest that the U.K. is a little bit more social democratic than we are. So I'm wondering, is that kind of protection of consumers just somewhere else, maybe not in the FSA and its enabling regulation. So maybe you want to talk about that a bit.

The argument about cost — and I think you do it systematically Dr. Ferran, anecdotally, and you're both doing it in a preliminary way and I think that's all we can take it [for]. I think you articulate elsewhere in your work, Professor Jackson, that it's hard to quantify cost and so also it's hard to quantify benefits. I mean, that's implicit. So I think we need the data, and it's good for people to take the data but one maybe overall question is then how do we quantify the benefits. How do you quantify a benefit such as consumer confidence or confidence in the financial system. I think that's part of what Congress has struggled with in the recent legislation. So you've overregulated having CEO's and CFO's certify financial statements and do all these silly things. But, you know, they're struggling with this notion of addressing confidence in a cost-benefit, that's a hard problem to deal with in a cost-benefit way.

So those are a few brief comments. Maybe you could talk about them, then we could take some questions from the floor.

PROFESSOR JACKSON: Well, let me jump into the normative breach for a second. I do have a normative angle. But it's more U.S.-oriented.

The reason I got into this project was my sense that people are not aware of the costs of our regulatory structure. And when an argument is made about separation of authority or federalist arguments . . . the costs are not always apparent. And I think from the United States perspective, one of the things that's very interesting about this study is how much more we're spending on financial services regulation than other countries are. Now, maybe we want to, maybe we don't. But I think it's very important to be explicit about what the costs are, and then, of course, proponents can make the case for the benefits outweighing it. But I think at least having this on the table — it's not generally on the table — is valuable.

So here the FSA and I have this sort of happy marriage. When they do the cost-benefit analysis, they're looking for a jurisdiction that's more costly than them that makes them look cost efficient. And we are their jurisdiction. We make them look good. The Europeans don't make them look good because they don't regulate that much. And then they'd say, well, but they're not really doing it. So they need us in their tables. But I think we need them in our tables too. Because I think a little bit the burden is on the American political system to explain why we're spending so much more on any normalized basis, particularly for banking, but also for securities.

So I do have a normative angle. And that's it. I think it's valuable even though it's methodologically really complex to make inter-jurisdiction comparisons. It's also very valuable, and the reason I actually got into this initially, was [because] developing countries need to have base lines to know how much they should spend on regulation. And it's nice for them to have benchmarks to make some comparisons to know whether they are up to some sort of snuff. Complicated to do, but valuable as well.

As to the question of whether the British are more socialist than we are, I think this is really complex. Go to National Health. Yes, they're more socialist than we are. Go to banking regulation, we're more socialist than they are. You go to regulation in general and I would say that we're more intensive financial regulators than anyone else in the world, even though we're common law and even though we're the Wild West. When you

actually get down to the nitty-gritty, we're more. You know, the world is more complex than my economic colleagues often recognize. And thank goodness.

DR. FERRAN: On the normative agenda point, I think my own perspective would be that in terms of the familiar arguments about the benefits of the single regulator efficiency, effectiveness, accountability, I do find the arguments quite finely balanced. And I do feel it's too early to say in terms of the U.K. whether we have evidence to support a claim to superiority.

What I do think, though, and I didn't have time to develop this, is that in terms of European financial regulation more generally, there are clear advantages in individual member states of the European Union, simplifying and reducing the number of their regulatory agencies so as to facilitate more ease of relationships at the European level. And I think that is an infinitely preferable way to develop European regulation generally as opposed to the development, say, of a Euro SEC or even a Euro FSA.

PROFESSOR BERMAN: Five minutes? Let's try to get a couple questions from the floor. The gentlemen in the back there.

QUESTION FROM AUDIENCE: [Unintelligible]

PROFESSOR JACKSON: To use the framework that Dr. Ferran offered about the pros and cons. If you just said a consolidated supervisor, if we did what the U.K. did and got an institution with roughly 50,000 employees and a budget of $4.5 billion doing consolidated supervision in the United States, I personally think that would be a bad idea. I think the problems of inefficiencies of scope, I think the massive political concerns about getting everybody in the same place would really be paramount. And in that way I just think the United States system is really quite different.

It's not totally clear to me whether we should be comparing ourselves with the U.K. or the E.U. as the right method of comparison. We're doing this country to country thing because that's what we've traditionally done. But in fact it's complicated. And if you look at the E.U. you'll see this two level system, much lighter touch at the top, very thin in terms of personnel and strong national system. But that is another model.

I think that if we were going to go, if you'd ask my druthers, I would have more consolidation at the federal level, bringing some insurance stuff up. There's a whole bunch of things that

one might do. But I have to say, the politics make me despair so much that I quickly move to second best, which is coordination strategies as opposed to consolidation strategies. Which is what we've done in the SWAPS area, task forces that coordinate, and other kinds of memoranda of understanding. I think that's the practical route for us in the near term.

QUESTION FROM AUDIENCE: Professor Jackson, one thing which struck me about your $4.5 billion was how little it is. I mean, I assume that the people at Enron and WorldCom probably stole more than that [laughter] isn't it fair to conclude that what we do is tiny and what France and Germany will do is zero.

PROFESSOR JACKSON: Right.

QUESTION FROM AUDIENCE: So why are we so concerned about cost. The cost is nothing. What's $4.5 billion in this country?

PROFESSOR JACKSON: I like the way you think. But that's the question. I mean, the suggestion of the data that I put out is that someone's got it wrong. France and Germany are the cases. And the FSA is an intermediate case. And I guess what I would say back to you is, what's so bad about France and Germany? What are we getting that they're not getting? We got Enron. They didn't. So what do we buy exactly –

[CROSS-TALK]

PROFESSOR JACKSON: I think this is a great point to debate. But I also agree — compared to our economy, $4.5 billion is not what it used to be.

QUESTION FROM AUDIENCE: Professor Jackson, have you done anything to divide that $4.5 billion at the federal level and the state level? . . .

PROFESSOR JACKSON: Right. That's a good question. To get the $4.5 billion we had to start with the states. But I have not done that kind of analysis. But what I've given you here is just a little piece of a bigger or longer term project. That's something we will definitely look at and I haven't done yet.

PROFESSOR BERMAN: I think we're going to wrap it up here. The only thing I'd like to add as a final word is that the most recent exercise in governmental regulatory consolidation in the United States, the creation of the Department of Homeland Security, has not exactly been a model of anything. And gives one pause as to whether, for a variety of political and

structural reasons, this could be done in as coherent a fashion in the United States as it was done in Britain.

SUPER REGULATOR: A COMPARATIVE ANALYSIS OF SECURITIES AND DERIVATIVES REGULATION IN THE UNITED STATES, THE UNITED KINGDOM, AND JAPAN

Jerry W. Markham[*]

I. INTRODUCTION

The value of competition among regulators has been the subject of debate in the United States ("U.S.") for some time.[1] On the one hand, its advocates contend that competing regulatory bodies will not only govern less, but also more efficiently.[2] Proponents of centralized regulation, on the other hand, argue that overlapping regulation is costly, inefficient, and allows exploitation and abuses along regulatory seams.[3] In supporting their arguments, however, both sides of this debate rely largely on intuitive arguments or anecdotal evidence. This is due to a lack of regulatory models that would provide a more substantive measure of the efficacy of a monolithic regulator over that of a more dispersed and competitive regulatory system. The Financial Services Authority in the United Kingdom

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1. *See generally* BLUEPRINT FOR REFORM: THE REPORT OF THE TASK GROUP ON REGULATION OF FINANCIAL SERVICES 8 (1984) [hereinafter BLUEPRINT FOR REFORM] (study considering effects of multiple regulators). The concept of competitive regulation is often referred to as "functional" regulation. *See, e.g.*, Melanie L. Fein, *Functional Regulation: A Concept for Glass-Steagall Reform*, 2 STAN. J. L. BUS. & FIN. 89, 90 (1995) ("According to its history, functional regulation seeks to promote competitive equality, regulatory efficiency, and investor/consumer protection.").

2. *See generally* Jonathan R. Macy, *The Business of Banking: Before and After Gramm-Leach-Bliley*, 25 J. CORP. L. 691, 713 (2000) (discussing why regulatory competition can be beneficial).

3. *See generally* Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441, 459 (1998) (arguing for regulation of risk rather than function); Bert Ely, *Functional Regulation Flunks: It Disregards Category Blurring,* AMER. BANKER, Feb. 21, 1997, at 4 (criticizing competitive regulation).

("FSA-UK") and the Financial Services Agency in Japan ("FSA-Japan") are two agencies of recent vintage with a unified regulatory structure that should provide a basis of comparison with the competitive regulatory approaches of the U.S.

Part II of this Article first describes the development of competing U.S. regulatory bodies for banking, insurance, securities, and derivatives. Part III focuses on the regulatory roles of the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") and Part IV describes the competition between these two agencies and its effects. Part V discusses the changes within the structure of the financial markets that affected the regulatory climate. After that review, Parts VI and VII examine the roles of the FSA-UK and FSA-Japan. Finally, Part VIII discusses the arguments for and against competitive regulation and attempts to discern whether a unified regulatory structure such as those in Japan and the United Kingdom ("U.K.") is preferable to the competitive approach of the SEC and CFTC.

II. FUNCTIONAL OR COMPETITIVE REGULATION IN THE U.S.

A. Banking

While the regulation of the financial services industry has been widely dispersed among a number of regulators, this decentralization is a reflection of history rather than design. Banking regulation is illustrative.[4] The federal government exercised an indirect role in the regulation of banking through the First and Second Banks of the U.S., until President Andrew Jackson crushed that institution in the fight over the renewal of its charter,[5] leaving a regulatory vacuum that the states filled with their own banking commissions.[6]

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4. *See generally* Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221 (2000) [hereinafter Markham, *Banking Regulation: Its History and Future*].

5. *See generally* CLAUDE G. BOWERS, THE PARTY BATTLES OF THE JACKSON PERIOD 222–26 (1922) (describing this political battle between Andrew Jackson and Henry Clay); ROBERT V. REMINI, HENRY CLAY: STATESMAN FOR THE UNION 397-99 (1991) (same).

6. The states had already imposed some regulatory requirements on banks, but the "bank mania" that followed the destruction of the Bank of the U.S. and the Panic of 1837, which was also precipitated by Jackson, led to the

The Civil War and the disarray of the nation's currency led to the introduction of federal bank regulation that established the national banks and gave regulatory authority over these institutions to the Comptroller of the Currency.[7] This created a "dual" system of banking regulation — state and federal — which is said to have:

> [F]ostered what is probably the greatest mass of redundant, otiose, and conflicting monetary legislation and the most complex structure of self-neutralizing regulatory powers enjoyed by any prominent country anywhere. It has put the federal government and the states in competition for the number and size of banks under their respective jurisdictions . . . .[8]

The creation of the Federal Reserve Board in the wake of the Panic of 1907[9] and the Federal Deposit Insurance Corporation ("FDIC") after widespread banking failures at the outset of the Great Depression in the 1930s,[10] added further layers to this regulatory competition. If that were not enough, Congress and the states also provided separate regulation for savings banks[11] and credit unions.[12]

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creation of more formal banking commissions or departments. Markham, *Banking Regulation: Its History and Future, supra* note 4, at 226–27.

7. National Bank Act of 1864, ch. 106, 13 Stat. 99 (codified as amended in scattered sections of 12 U.S.C.).

8. BRAY HAMMOND, SOVEREIGNTY AND AN EMPTY PURSE: BANKS AND POLITICS IN THE CIVIL WAR 349–50 (1970).

9. *See generally* 1–2 PAUL M. WARBURG, THE FEDERAL RESERVE: ITS ORIGIN AND GROWTH (1930).

10. Banking Act of 1933, ch. 89, 48 Stat. 162, 168–69. One in four banks in the U.S. failed during the bank panic. *The Bubble Burst*, LIFE, Spring 1992, at 26.

11. States had overseen the operations of building and loan societies and savings banks since their appearance early in the nineteenth century. Federal charters for savings banks were not available until 1978. LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 79–81, 87 (2001). The Federal Home Loan Bank Act of 1932 created the Federal Home Loan Bank Board to charter and supervise federal savings and loan associations. Federal Home Loan Bank Act, Pub. L. No. 107-252, 47 Stat. 725 (1932) (codified as amended at 12 U.S.C. § 1421 (2000)). Federal insurance for these institutions was created by the National Housing Act 1934, ch. 847, 48 Stat. 1246 (codified as amended at 12 U.S.C. § 1724 (2000)), *repealed* by Act of Aug. 9, 1989, Pub. L. No. 101-73, tit. IV, § 407, 103 Stat. 363.

12. Federal Credit Union Act, Pub. L. No. 107-252, 48 Stat. 1216 (1934) (codified as amended at 12 U.S.C. § 1759 (2000)), authorized national charters

The Great Depression had even broader effects in fostering the balkanization of regulation in financial services. The activities of banks were already limited in scope by statute,[13] but the Glass-Steagall Act sought to further seal off banking from other financial service businesses by prohibiting banks from dealing in investment banking activities.[14] No justification has ever been shown for this prohibition,[15] and Senator Glass himself unsuccessfully sought its repeal one year after adoption.[16] Nev-

for credit unions. *See* Nat'l Credit Union Admin. v. First Nat'l Bank & Trust Co., 522 U.S. 479, 479–85 (1998) (describing scope of Federal Credit Union Act). Most states already had legislation regulating such entities after President William Howard Taft wrote to the states in 1908, asking them to enact authorizing legislation for credit unions. BROOME & MARKHAM, *supra* note 11, at 89.

13. Traditionally, banks had no power to engage in commercial and real estate transactions, except to secure a debt or as an accommodation to a customer. 1 CARL ZOLLMANN, THE LAW OF BANKS AND BANKING §§ 223, 224 (1936). *See also* Jemison v. Citizens Savings Bank of Jefferson, 25 N.E. 264 (N.Y. Ct. App. 1890) (bank could not deal in cotton futures as either principal or agent). The National Bank Act of 1864 also limited national bank activities in a similar fashion. *See generally* First Nat'l Bank of Charlotte v. National Exchange Bank of Baltimore, 92 U.S. 122 (1875) (discussing limitations on the operations of national banks). The Bank Holding Company Act of 1956 sought to further circumscribe the activities of banks by limiting the operations of entities within a bank holding company structure to "activities so closely related to banking or managing or controlling banks as to be a proper incident thereto." Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133 (codified as amended at 12 U.S.C. § 1843(c)(8) (2000)).

14. The Glass-Steagall Act was a part of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). *See* Securities Industry Assoc. v. Board of Governors of the Federal Reserve System, 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988) (describing provisions of the Glass-Steagall Act).

15. The Glass-Steagall Act was concerned principally with the operations of the securities affiliates operated by several large banks, the most important of which was the First National City Co. affiliated with the National City Bank (now Citigroup). The affiliates had been created despite a ruling from the Solicitor General of the U.S. that such operations were not permitted by the National Bank Act. 2 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTOR (1900–1970), at 57–58 (2002) [hereinafter 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S.]. A study of some 3,000 national bank failures before 1936 found that bank securities activities were low on the list of factors that resulted in bank insolvencies. A representative from the Federal Reserve Board also testified during the hearings on the Glass-Steagall legislation that such a prohibition was unnecessary. *Id.* at 168.

16. *Id.* at 371.

ertheless, the legislation remained the "'Maginot Line' of the financial world,"[17] excluding banks from many of the financial activities of broker-dealers until its repeal in 1999 by the Gramm-Leach-Bliley Act ("GLBA").[18]

B. Insurance

Another sector of the financial services industry is insurance. It too owes its competing regulatory structure to history. The states had gradually imposed regulation on insurance companies to prevent abuses and regarding the maintenance of resources adequate to meet claims.[19] A scandal in the insurance industry at the beginning of the twentieth century resulted in an investigation by a legislative committee of the New York legislature.[20] Headed by State Senator William Armstrong, the investigation uncovered several abuses resulting in legislation that, among other things, barred the insurance industry from underwriting and other securities activities, restricted its ability to invest in stocks, and separated insurance companies from the banking industry.[21] Since New York was then the center of insurance, its lead was followed by other states.

Thereafter, the doctrine of unexpected consequences came into play. Sealed off from the securities industry, the insurance companies could not participate in the market excesses of the 1920s and thus avoided the devastation visited on investors fol-

17. Bevis Longstreth, *Current Issues Facing the Securities Industry and the SEC*, Address Before the Securities Industry Association, May 4, 1982, *quoted in*, Jonathan Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, 5 (1984).

18. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 and 15 U.S.C.).

19. Massachusetts regulated its insurance companies in 1837 and New York in 1851. Lissa L. Broome & Jerry W. Markham, *Banking and Insurance: Before and After the Gramm-Leach-Bliley Act*, 25 IOWA J. CORP. L. 723, 728 (2000).

20. *Id.* at 730. The Committee was formed after news reports that James Hyde, a twenty-three year old heir who had assumed control of the Equitable Life Assurance Co. in New York, had thrown a $100,000 party at Sherry's restaurant. *Id.* Concern was expressed that Hyde was looting the insurance company to fund his extravagant life style. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 18–20. Among the attendees at the party at Sherry's was Franklin D. Roosevelt. DENIS BRIAN, PULITZER: A LIFE 299 (2001).

21. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 18–20.

lowing the Stock Market Crash of 1929. The insurance companies also escaped the massive failures in the banking sector and thus eluded the scrutiny of President Roosevelt and Congress in the New Deal legislation regulating banking and commodity futures. But this escape was a narrow one — the Temporary National Economic Committee ("TNEC") rejected an SEC proposal to create a federal agency to regulate insurance companies only after vigorous opposition from the industry.[22]

The next federal regulatory threat came from the Supreme Court's decision in *United States v. South-Eastern Underwriters Association*,[23] which held that the insurance industry was subject to the federal antitrust laws. There was fear that this would impair the ability of insurance companies to pool statistics and preempt state regulation. Receptive to such concerns, Congress then passed the McCarran-Ferguson Act,[24] which granted insurance companies immunity from the antitrust laws to the extent that they were regulated by state insurance laws.

The McCarran-Ferguson Act largely excluded any federal regulation until insurance companies began offering variable annuities in 1952.[25] The SEC claimed that variable annuities were securities subject to regulation under the federal securities laws because returns were based on the investment of the annuitants' premium payments in securities. The Supreme

22. Another SEC proposal would have allowed federal agents to inspect insurance companies, but it too failed to be adopted. The SEC also wanted insurance companies, which were one of the largest sources of finance for large corporations, to invest in greater amounts of common stocks. Corporate balance sheets were becoming over-leveraged by debt sold to the insurance companies, and this concerned the TNEC, as well as the SEC. *Id.* at 245–50.

The insurance industry defeated these proposals by pointing out that avoiding stocks as an investment for insurance company reserves had saved the industry from disaster when the market collapsed in the wake of the Stock Market Crash of 1929. TNEC, *Investigation of Concentration of Economic Power*, Monograph No. 28A: Statement of Life Insurance, 76th Cong., 3d Sess. 4 (1941).

23. United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).

24. McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011–15 (2000)).

25. The variable annuity was the invention of the College Retirement Equities Fund ("CREF"), an affiliate of the Teachers Insurance and Annuity Association ("TIAA"). *See* CEDRIC V. FRICKE, THE VARIABLE ANNUITY: ITS IMPACT ON THE SAVINGS-INVESTMENT MARKET 2 (1959).

Court found for the SEC in these cases,[26] resulting in dual regulation of insurance companies selling variable contracts, as they were required to separate reserves for such products from reserves for more traditional insurance.[27]

Despite some frightening losses in the late 1980s that led to calls for federal regulation, the insurance industry was able to avoid most other federal intrusions.[28] What the industry could not avoid, however, was competition from the banking and securities industries. This was because the variable annuity was a product that was sold by stockbrokers, who did so in large numbers.[29] Federal bank regulators also opened the door for banks to sell insurance products in the 1990s.[30] This resulted in a restructuring of the insurance industry — insurance companies demutalized and expanded their own financial service offerings.[31]

C. Securities

Further separation of financial services into distinct sectors came through the adoption of legislation to regulate the securities industry during the Great Depression. The SEC's history and background is well-known[32] — it was a product of the Stock Market Crash of 1929 and the subsequent depression.[33] The

26. SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959).

27. Broome & Markham, *supra* note 19, at 737.

28. *See id.*

29. *See id*. at 743 (describing broker-dealer competition).

30. The banks used a statute that many thought had been repealed to gain entry into the insurance industry. *See* U.S. Nat'l Bank of Oregon v. Indep. Agents of Am., 508 U.S. 439 (1993). *See also* Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25 (1996) (states unable to restrict banks from selling insurance).

31. Broome & Markham, *supra* note 19, at 745–46.

32. For the uninitiated, see generally JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE (1995).

33. The causes of the Stock Market Crash of 1929 are still widely debated. Blame is attributed to, *inter alia,* excessive speculation through margin accounts and abusive market practices, such as the organized pools that operated in over one hundred NYSE stocks in the 1920s. More recent focus has centered on the blunders of the Federal Reserve System, which first eased credit in order to support England's effort to return to the gold standard, thereby boosting the market. The Federal Reserve then reversed course and sought to curb the market through ill-conceived interest rate increases, an

SEC, which was ultimately given regulatory authority over the statutes that now comprise the federal securities laws, operates on a principle of full disclosure.[34] In adopting this legislation, Congress did not preempt the regulation of sales of securities under state blue-sky laws, thereby creating a competing layer of governmental regulation that was not lessened until late in the twentieth century.[35] Aside from some tinkering principally de-

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echo of recent events. There is also the possibility that the market was simply over-heated and needed correction. *See* 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 143–45, 150–53. Similar controversy exists over what caused and prolonged the Great Depression. Some claim that the market crash itself caused the depression — *post hoc, ergo propter hoc*. Indeed, recessions and depressions often follow a market crash, but that may suggest no more than that the market anticipates the economic decline. Today, most economists seem to agree that the Stock Market Crash of 1929 was not the cause of the Great Depression or its impressive duration. *See generally* Marco A. Espinosa-Vega & Jang-Ting Guo, *On Business Cycles and Countercyclical Policies; Statistical Data Included*, 86 ECON. REV. 1 (2001) (discussing economic theories on causes of the Great Depression). One author has even stated that the Stock Market Crash of 1929 "was probably an event of relatively minor significance" in causing the Great Depression. CHARLES R. MORRIS, MONEY, GREED, AND RISK: WHY FINANCIAL CRISES AND CRASHES HAPPEN 73 (1999). *See also The Crash of 1929 — A New View*, WALL ST. J., Oct. 28, 1977, at 16 (blaming tariff increases and increases in income tax).

34. The statutes administered by the SEC are the Securities Act of 1933, 15 U.S.C. § 77a–77bbbb (2000) (requiring full disclosure in connection with new offerings of securities to the public); the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm (2000) (creating the SEC and requiring continual financial reporting by public companies, providing SEC regulatory control over proxy solicitations and tender offers, and regulating the secondary markets in publicly owned securities); the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79–79z-6 (2000) (simplifying the holding company structure of public utilities); the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-bbbb (2000) (regulating the administration of debentures issued under trust indentures); the Investment Company Act of 1940, 15 U.S.C. 80a-1 to 80a-64 (the world's most complex statute seeks to regulate investment companies, including mutual funds); and the Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2000) (regulating and registering investment advisors).

35. The National Securities Markets Improvement Act of 1996 preempted much state securities regulation or required the states to conform their standards to those of the SEC. The act exempted Nasdaq and exchange listed stocks from state regulation. Also exempted were investment companies and investment advisers with significant amounts of funds under management. State broker-dealer record-keeping, net capital, and other requirements regulating such entities were required to conform to those of the SEC. The SEC broadened its record-keeping requirements for broker-dealers to address the states' fear that such preemption would frustrate their regulation of broker-

signed to increase regulation, the federal securities laws remain more or less in the form arrived at in the 1930s.[36]

Another competing regulatory structure also remains — that of the self-regulatory organizations ("SROs"). These non-governmental organizations were given regulatory authority,

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dealers. *See generally* 23A JERRY W. MARKHAM & THOMAS LEE HAZEN, BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 6.02 (2001) (describing SEC rule amendments).

36. Tinkering may be a bit of an understatement. For example, amendments were made in 1964 to strengthen financial reporting by public companies. 15 U.S.C. § 78m(a) (2000). *See generally* Richard Phillips & Morgan Shipman, *An Analysis of the Securities Acts Amendments of 1964*, 1964 DUKE L.J. 706. In 1968, the Williams Act began regulating tender offers and played an important role in the merger mania of the 1980s. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. § 78n(d)–(f) (2000)). For a description of the Williams Act, see Miriam P. Hechler, *Toward a More Balanced Treatment of Bidder and Target Shareholders*, 1997 COLUM. BUS. L. REV. 319. In 1970, after a "paperwork crisis" that resulted in the failure of numerous firms, Congress created the Securities Investor Protection Act ("SIPA") and the SIPA Corporation ("SIPC") that provides insurance for broker-dealer bankruptcies. 15 U.S.C. § 78aaa (2000). For a description of the problems that led to the paperwork crisis and the creation of SIPA, see SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKERS AND DEALERS, REPORT AND RECOMMENDATIONS, H.R. DOC. NO. 91-231 (1971). Legislation enacted in 1975 regulated clearing and settlement activities, imposed more stringent regulation over broker-dealer operations, established regulation over municipal bond dealers, and sought to create a national market system. For a description, see S. REP. NO. 94-75 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179; H.R. REP. NO. 94-123 (1975). Dealers in U.S. government securities were regulated after scandals involving unregistered "repo" dealers. Government Securities Act of 1986, Pub. L. No. 99-571, 100 Stat. 3208 (1986). For a description of the problems in the repo market, see H.R. REP. NO. 99-258 (1985); S. REP. NO. 99-426 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5395; *Regulating Government Securities Dealers: Hearing on H.R. 2032 Before Subcomm. On Telecomm., Consumer Prot., and Fin. of the House Comm. on Energy and Commerce,* 99th Cong. 201–13 (1985) (Report by John S. R. Shad, Chairman, Securities and Exchange Commission (June 20, 1985)). Insider trading sanctions were also strengthened after a series of scandals. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. § 78u(d) (2000)); Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended at 15 U.S.C. §§ 78t-1, 78u-1 (2000)). For a description of those scandals, see DAVID A. VISE & STEVE COLL, EAGLE ON THE STREET (1991). Additional legislation was enacted to deal with penny stock fraud after a series of swindles. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified as amended at 15 U.S.C. 78q-2 (2000)).

and shelter from the antitrust laws,[37] by the Securities Exchange Act of 1934,[38] under which the exchanges, and later the National Association of Securities Dealers, Inc. ("NASD"),[39] are required to regulate the conduct of their members. The role of the SEC in this self-regulation is to oversee the exchanges, as well as to act directly where SRO oversight fails.[40] The SRO concept actually added several layers of regulators. In addition to the NASD and the New York Stock Exchange ("NYSE"), the SROs came to include the regional exchanges (e.g., the American Stock Exchange and the Philadelphia Stock Exchange) and the Chicago Board Options Exchange, Inc. ("CBOE"). The creation of the Municipal Securities Rulemaking Board added another element of self-regulation that gave rulemaking authority to this entity, but left enforcement with the SEC and bank regulators.[41]

Though the SROs generally attempt to coordinate their regulation in order to avoid duplication, there has been some competition among the SROs (such as the rivalry between the stock exchanges over options trading once it became clear that the CBOE would succeed).[42] The SEC initially sought to quash the

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37. Gordon v. New York Stock Exchange, 422 U.S. 659 (1975); United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 734–35 (1975); Silver v. New York Stock Exchange, 373 U.S. 341 (1963).

38. 15 U.S.C. § 78f (2000).

39. Self-regulation by the NASD was added in 1938 by the Maloney Act, 52 Stat. 1070 (codified as amended at 15 U.S.C. § 78o-3 (2000)). *See generally* United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694 (1975) (discussing role of NASD).

40. This process has been most vividly described by Supreme Court Justice William O. Douglas, a former SEC chairman. His concept of self-regulation is:

> [O]ne of letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.

WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 82 (James Allen ed., 1940).

41. *See* 15 U.S.C. § 78o-4(b)(1), (c) (2000).

42. The American Stock Exchange was the first to seek to add options trading to its products after the creation of the CBOE. In the Matter of the American Stock Exchange, Inc. Plan to List and Trade Options, Exchange Act Release No. 34-11,144, (Dec. 19, 1974), 1974 SEC LEXIS 2108. The NYSE was at first uninterested in options trading and encountered opposition from the SEC when it did seek entry in later years. The SEC feared that options traded on the NYSE would be subject to abuse by specialists. It also expressed a similar concern with market makers trading over-the-counter op-

competition by requiring coordinated trading and clearance[43] under the aegis of a "central market" doctrine, adopted early in the 1970s.[44] After endeavoring to regulate competition on the

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tions. *See* Termination of the Options Moratorium, Exchange Act Release No. 34-16,701, 19 S.E.C. Docket 998 (Mar. 26, 1980). This concern with side-by-side trading was not overcome by the SEC until 1985. It then allowed the NYSE to trade options, but required the exchange to conduct such trading from a location separate from its stock trading floor. 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (1970–2001), at 53 (2002) [hereinafter 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S.]. By that time, the market was too mature for successful competition by the NYSE, and it transferred its options operations to the CBOE in the mid-1990s. Dan Colarusso, *Investing: A New Options Market That Hums*, N.Y. TIMES, Dec. 16, 2001, Sec. 3, at 7.

43. Jerry W. Markham & David J. Gilberg, *Stock and Commodity Options — Two Regulatory Approaches and Their Conflicts*, 47 ALBANY L. REV. 741, 749–50 (1983).

44. As noted by one authority:

> [I]n 1971, in a letter transmitting its Institutional Investor Study to Congress, the SEC stated: "A major goal and ideal of the securities markets and the securities industry has been the creation of a strong central market system for securities of national importance, in which all buying and selling interest in these securities could participate and be represented under a competitive regime."
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> The SEC acknowledged that "this represented something of a shift in the historic position of the Commission, which over many years, extending from before World War II to at least the Special Study Report of 1963, tended to favor competing but separate markets." The shift was prompted not by any lessened concern over the dangers of consolidation, but, rather, by the *deus ex machina* of modern technology. The SEC and others saw in the technological developments in communications and computers a way to capture the benefits of consolidation without inhibiting competition.
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> In 1975, Congress indicated that it agreed with the SEC, enacting the Securities Acts Amendments of 1975, which called for the SEC to "facilitate the establishment of a national market system for securities." In this national market system the efforts of individual marketplaces to achieve consolidation at the expense of other marketplaces were to be displaced by a much grander national effort that would no longer recognize marketplace boundaries.

Jeffry L. Davis & Lois E. Lightfoot, *Fragmentation Versus Consolidation of Securities Trading: Evidence from the Operation of Rule 19c-3*, 41 J. L. & ECON. 209, 210–11 (1998).

The central market got nowhere in the stock markets. The SEC sought to require a "universal message switch" that would have required customer orders to be routed to the market with the best execution price. The agency was unable to mandate such a system and instead agreed to the creation of

options exchanges for many years, the SEC finally began encouraging the multiple trading of options on the same securities.[45] Still, after the creation of the Nasdaq market the competition between the NYSE and the NASD was even fiercer,[46] and in later years led to criticism that the NASD had allowed its competitive role in marketing Nasdaq to outweigh its regulatory responsibilities.[47] In the end, the NASD was forced to separate and spin off its regulatory body into NASD Regulation, Inc. ("NASDR").[48]

The SEC regulatory structure also increased in complexity over the years with the introduction of other entities that have now been designated "gatekeepers,"[49] such as the accountants that certify the financial statements of public companies and broker-dealers.[50] Accountants had maintained control over

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the "Intermarket Trading System," under which exchange specialists execute orders at the best price available on any other exchange. This essentially meant that specialists on the regional exchanges would have access to NYSE quotes and could key off those quotes instead of competing separately. *See generally* U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, ELECTRONIC BULLS AND BEARS: U.S. SECURITIES MARKETS & INFORMATION TECHNOLOGY 47–48 (Sept. 1990) (description of universal message switch and Intermarket Trading System); U.S. GENERAL ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL COMMITTEES ON SECURITIES TRADING: SEC ACTION NEEDED TO ADDRESS NATIONAL MARKET SYSTEM ISSUES (March 1990) (description of central market system issues).

45. The SEC has been allocating options on particular stocks to the options exchanges by lottery. It was not until 1989 that the SEC allowed options on particular securities to be traded on more than one exchange. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 85. Thereafter, it sought to encourage such trading. *See* Multiple Trading of Standardized Options, Exchange Act Release No. 34-26,870, 43 S.E.C. Docket 1498 (May 26, 1989). The options exchanges were censured in 2000 for agreeing not to multiply list options as mandated by the SEC. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 331.

46. Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 GEO. WASH. L. REV. 17 (1986) (description of development and growth of the Nasdaq market).

47. *See generally* In the Matter of National Association of Securities Dealers, Inc., Exchange Act Release No. 34-37,542, 62 S.E.C. Docket 1385 (Aug. 8, 1996) (describing collusion by Nasdaq market makers).

48. *Id.*

49. *See* Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491 (2001) (discussing role of gatekeepers and advocating liability).

50. The role of accountants was widely expanded by the adoption of the federal securities laws. Publicly owned companies were required to publish

their audit procedures for some time, though the SEC would occasionally intervene.[51] One concern was competition, i.e., that corporate management would shop for the least strict auditor. The SEC has attacked such practices,[52] and, further, adopted rules that sought to assure that auditors remained independent of their audit clients.[53] However, the independence standards were questioned after the SEC discovered that numerous partners in audit firms held stock in their audit clients.[54] Consulting operations created by accounting firms were also creating conflicts. As a result, the SEC acted to strengthen its independ-

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certified accounting statements. The SEC also imposed auditing requirements on broker-dealers. Reports to be Made by Certain Brokers and Dealers, 17 C.F.R. § 240.17a-5 (2002) (FOCUS report requirement).

The gatekeeper role of accountants, and their "deep pockets," led to efforts to impose liability under the federal securities laws when a company unexpectedly failed during an accounting firm audit. The Supreme Court relieved the accounting profession of liability under SEC Rule 10b-5 (17 C.F.R. § 240.10b-5 (2002)) based on negligence in their audits. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). Further protection was provided when the Supreme Court rejected private rights of action for aiding and abetting on the part of professionals such as accountants and lawyers. Central Bank v. First Interstate Bank, 511 U.S. 164 (1994).

51. The SEC deferred for the most part to the accounting profession in developing what are called "generally accepted accounting principles," or "GAAP." 2 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 9.6[1] (4th ed. 2002) [hereinafter HAZEN TREATISE]. The Financial Accounting Standards Board ("FASB"), an industry group, took the lead in developing or changing particular GAAP standards. *See generally* Marshall S. Armstrong, *The Work and Workings of the Financial Accounting Standards Board*, 29 BUS. LAW. 145 (1974) (describing role of FASB). Regulation S-X, however, imposed various accounting requirements in public offerings. Application of Regulation S-X (17 C.F.R. part 210), 17 C.F.R. §§ 210.1-01 to 210.1-02 (2002). The SEC has also adopted particular accounting standards in its filings by rule, and issues Accounting Series Releases on matters it deems not adequately addressed by the accounting profession.

Until recently, the American Institute of Certified Public Accountants ("AICPA") set "generally accepted auditing standards," or "GAAS." 2 HAZEN TREATISE, *supra* § 9.6[1]. The SEC further assumed the authority to discipline accountants that failed to meet what the agency deemed were appropriate auditing standards. 17 C.F.R. § 210.102(e) (2002).

52. 2 HAZEN TREATISE, *supra* note 51, § 9.6[1].

53. Qualifications of Accountants, 17 C.F.R. § 210.2-01(b) (2002).

54. In one large accounting firm, the SEC found that thirty-one of the top forty-three partners held stock in audit clients. A total of 8,000 violations of independence standards were found by partners and employees of the accounting firm. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 257.

ence standards.[55] Congress also jumped on the bandwagon and required auditors to report violations by their clients.[56] Most recently, the Enron debacle and other accounting scandals heightened regulatory concern over the role of these gatekeepers.[57] In the end, the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") created a Public Company Accounting Oversight Board to oversee the auditing principles and practices of auditors.[58]

Another set of gatekeepers is the Nationally Recognized Statistical Ratings Organizations ("NRSROs"), i.e., ratings agencies such as Moody's and Standard & Poor's. The SEC gave such organizations a quasi-official role in applying its net capital rule.[59] That status, and the increasingly important role of

55. Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 34-43,602, 65 Fed. Reg. 76,008 (Dec. 5, 2000).

56. Section 10A of the Securities Exchange Act of 1934 required audits to be conducted in accordance with GAAS. Independent auditors were required to conduct their audits in a manner that would uncover illegal activities and to report that conduct to management and to the board of directors if management fails to act. The board of directors must then report the violative activity to the SEC or if it fails to do so, the auditor must inform the SEC. 15 U.S.C. § 78j-1 (2000).

57. Enron Corporation was the seventh largest company on the Fortune 500 index when it failed in October 2001. After the Enron scandal, a number of other firms were also found to have engaged in various questionable accounting practices. Several energy companies were involved in "round trip" trades that artificially increased their income by billions of dollars. Global Crossing Ltd., a large telecommunications firm declared bankruptcy after an accounting scandal. It was followed by WorldCom, Inc., which had improperly booked some $7 billion in revenues. The bankruptcy of WorldCom was the largest such event in U.S. history, superseding Enron for that dubious honor. *See* Greg Hitt, *Bush Signs Sweeping Legislation Aimed at Curbing Corporate Fraud*, WALL ST. J., July, 31, 2002, at A4.

58. The Public Company Accounting Oversight Board took away control of accounting standards from the accounting profession. Accountants certifying the financial standards of public companies are now required to register with the Board and conform to the standards it sets. *See* Sarbanes-Oxley Act of 2002, §§ 101–09, Pub. L. No. 107-204, 116 Stat. 745. Some large accounting firms had already spun off consulting services (e.g., Accenture), and immediately after this legislation IBM purchased the consulting operations of another giant accounting firm. William Bulkeley & Kemba Dunham, *IBM Speeds Move to Consulting With $3.5 Billion Acquisition*, WALL ST. J., July 31, 2002, at A1.

59. For example, the SEC defers to the NRSROs in determining whether a "ready market" exists for purposes of valuing securities in inventory under its net capital rule. *See, e.g.*, Net Capital Requirements for Brokers and Dealers, 17 C.F.R. § 240.15c3-1(c)(2)(vi)(E) (2002) (valuation of money instruments);

the ratings agencies, created the impression that these entities were gatekeepers. Although NRSROs compete with each other for business, critics have claimed that the ratings agencies do not fulfill their gatekeeping responsibilities due to the conflict of interest they face, i.e., their compensation is paid by the very companies they rate.[60] Sarbanes-Oxley now requires the SEC to conduct a study of the NRSROs and to report to Congress on any deficiencies, raising the likelihood that these gatekeepers will be subject to regulation in the future.[61]

Financial analysts are another class of securities sector participants that have been elevated to gatekeeper status. The Investment Advisers Act of 1940 first applied some regulation to this field.[62] However, Congress sought to limit this regulation to those entities rendering personal advice, which excluded publications to the general public, a distinction the SEC was unable to discern.[63] Financial analysts have also been a particularly sharp thorn in the SEC's side. While the analysts' product value depends to some degree on their ability to analyze the massive amounts of information influencing the value of the stocks, the real value they added over the years was their ability to obtain information that was not generally available to

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Capital Committee of the Securities Industry Association (c/o Merrill Lynch & Co.), SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,280, at 77, 051 (June 12, 1992) ("ready market" treatment for debt securities of foreign issuers).

60. *See generally* Frank Partnoy, *The Siskel and Ebert of Financial Markets? Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619 (1999) (describing shortcomings of rating agencies). The rating agencies were also criticized for not predicting the demise of the Enron Corporation. *See* Hearings before the United States S. Comm. on Governmental Affairs, 107th Cong. (2002) (testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law).

61. Sarbanes-Oxley Act of 2002, § 702.

62. Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2000). The investment adviser is relatively new to the securities industry, having appeared in force only after World War I. SECURITIES AND EXCHANGE COMMISSION, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, REPORT OF THE SECURITIES AND EXCHANGE COMMISSION PURSUANT TO SECTION 30 OF THE PUBLIC UTILITIES HOLDING COMPANY ACT OF 1935: INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT FUTURE PRICES, AND INVESTMENT ADVISORY SERVICES 3 (1939) ("The emergence of investment counselors as an important independent occupation, or profession, did not appear until after the close of the World War").

63. Lowe v. SEC, 472 U.S. 181, 211 (1985).

the public. The SEC's mandate was full disclosure, but the agency wanted such disclosure only on its terms, prompting it to bring an insider trading case against an analyst that sold out his institutional clients when he learned of a massive fraud at Equity Funding, a company he had been following.[64] The Supreme Court threw out the case,[65] but the SEC remained concerned with the role of financial analysts.[66] Selective disclosure given to analysts by corporate officials was an informational advantage at which the SEC balked, and subsequently proscribed under Regulation FD.[67]

Denied this informational advantage as a product to sell, analysts were left to tout stocks like snake oil salesmen.[68] This led to scandal when it was discovered that Henry Blodget, an analyst at Merrill Lynch, had been publicly praising one stock while describing it as a "piece of junk" in an internal email.

64. Mitchell C. Lynch, *Security Analysis and the Law*, WALL ST. J., Sept. 15, 1978, at 16.

65. Dirks v. SEC, 463 U.S. 646 (1983).

66. Broker-dealers are required to maintain a "Chinese Wall" (an "inviolable wall" for the politically correct) between the analysts and the underwriting arms of the firm. Restricted lists are also used to assure that analysts do not have access to non-public information. *See generally* David A. Lipton & Robert B. Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459 (1975).

67. General Rule Regarding Selective Disclosure, 17 C.F.R. § 243.100 (2002). This regulation seems to be based on a bit of twisted government logic, i.e., full disclosure to everyone at the same time or no disclosure to anyone. In the apparent view of the SEC, it is better that the market not receive information that will more efficiently value a company unless everyone has the information at precisely the same time. The SEC should be encouraging information flows, not discouraging access by professionals who will be paid for ferreting out material information, analyzing it, and disseminating it to the market through their clients. *See generally* Jerry Duggan, *Regulation FD: SEC Tells Corporate Insiders to "Chill Out,"* 7 WASH. U. J.L. & POLICY 159 (2001) (criticizing Regulation FD).

68. Mary Meeker, an analyst at Morgan Stanley, was given the title of "queen of the net" for hyping IPO internet stock offerings that her firm was underwriting. JOHN CASSIDY, DOT.CON, THE GREATEST STORY EVER SOLD 206-17 (2002). *See also generally* Randall Smith & Susanne Craig, *Will Grubman Case Tone Down the Exaggeration by Analysts?*, WALL ST. J., Sept. 24, 2002, at C1. Jack Grubman, an analyst at Salomon Smith Barney, was alleged to have pumped telecommunications stocks so that his firm could obtain their underwriting business. Charles Gasparino, *Salomon's Grubman Resigns: NASD Finds "Spinning" at Firm*, WALL ST. J., Aug. 16, 2002, at A1; Charles Gasparino, *Salomon Agrees to Settle Stock-Hype Case*, WALL ST. J., Sept. 24, 2002, at C1.

Merrill Lynch was fined $100 million after this was discovered.[69] The fine was imposed by Eliot Spitzer, the New York State Attorney General, whose recent crusades provide evidence of another layer of regulation in the securities industry.[70] Finally, Sarbanes-Oxley sought to further separate the analysts from their investment banking associates and gave the SEC authority to adopt rules for that purpose.[71] The SEC, thereafter, began examining proposals to require analysts to be independent of their investment banking colleagues.[72]

Sarbanes-Oxley added still another gatekeeper, as the SEC was given authority to issue rules setting forth standards of conduct for attorneys advising public companies.[73] Attorneys are now required to report violations of securities laws, *inter alia*, to a board committee composed entirely of outside directors if the company fails to take corrective action.[74] This means that lawyers are now policemen and not just advisors.[75] Moreover, the reference to outside directors is further evidence of yet another gatekeeper — the outside director himself.[76] The SEC has long attempted to strengthen the role of these directors, to

69. Patrick McGeehan, *E-Mail Gaps May Mean Fines for Big Firms*, N.Y. TIMES, Aug. 2, 2002, at C1.

70. *See infra* note 429 and accompanying text.

71. *See* Sarbanes-Oxley Act of 2002, § 501, Pub. L. No.107-204, 116 Stat. 745 (2002).

72. Michael Schroeder, *SEC to Consider Step in Analysts' Independence*, WALL ST. J., Sept. 9, 2002, at C7.

73. The SEC adopted the Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release Nos. 33-8185, 34-47,276, 17 C.F.R. Part 205 (S.E.C. Jan. 29, 2003), *available at* www.sec.gov/rules/final/33-8815.htm.

74. 17 C.F.R. § 205.3(b)(3); Sarbanes-Oxley Act of 2002, § 307.

75. Such a role for lawyers had been rejected many years ago. A scandal at the National Student Marketing Corporation resulted in a drive by the SEC to punish lawyers representing companies violating the federal securities laws. *See* Stan Crock, *SEC to Consider Rule Requiring Lawyers to Disclose Fraud by Corporate Clients*, WALL ST. J., Aug. 3, 1978, at 5 (American Bar Association asserts that lawyers are advisors and not policemen). However, the SEC later rejected a proposal that would have required corporate lawyers to report management wrongdoing to the board of directors and to the SEC. *See SEC Rejects Bid to Force Firms' Lawyers to Tell Boards of Employee Wrongdoing*, WALL ST. J., May 1, 1980, at 4 (SEC defers to ABA on this issue).

76. The NYSE has also ruled that outside directors must constitute a majority of the board of directors of publicly owned corporations listed on the exchange. Gaston Ceron, *Deals & Deal Makers: NYSE to Firm Governance, Add Trading Floor*, WALL ST. J., Aug. 2, 2002, at C5.

the point of seeking to require all but one director to be independent of management, thereby leaving the running of a company in the hands of those unfamiliar with its day-to-day operations.[77] Finally, various "whistleblower" statutes seek to protect employees reporting misconduct.[78] One such employee achieved fame for reporting Enron's questionable accounting practices to senior management before they became publicly known.[79] Sarbanes-Oxley enshrines her act into legislation by requiring public corporations to adopt procedures to encourage such whistleblowing.[80]

If all of these gatekeepers and regulators are not enough, there are still real gorillas to contend with — the private attorneys general bringing class action lawsuits under the federal securities laws.[81] As corporate America was drowning in a mo-

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77. *See* Burt Schorr, *Board Breakup, Corporate Directors Scored for Lax Scrutiny of Managements' Acts*, WALL ST. J., Apr. 10, 1978, at 1 (describing efforts by SEC to make corporate board more independent of management). In 1978 the NYSE began requiring its listed companies to have an audit committee composed of outside directors. Peter F. Drucker, *The Real Duties of a Director*, WALL ST. J., June 1, 1978, at 20. An SEC Chairman went so far as to advocate that management should have only one slot on the board of directors. *Management Should Fill Only One Seat on of Firms' Board of Directors*, WALL ST. J., Jan. 19, 1978, at 3. The SEC Chairman soon had to backtrack from this wild proposal. *Letters to the Editor*, WALL ST. J., Nov. 2, 1978, at 22. *Compare*, Joann S. Lublin, *Outsiders In, Firms Add More Independent Directors, But Finding Doing So Can Mean Headaches*, WALL ST. J., May 26, 1978, at 38 (describing shortcomings of outside directors), *with*, Joann S. Lublin, *How CEOs Retire in Style*, WALL ST. J., Sept. 13, 2002, at B1 (describing twenty-four years later lucrative compensation given to executives after negotiation with independent directors). *See generally SEC Report Warns Outside Directors of Duty to Investors*, WALL ST. J., Jan. 18, 1978, at 3 (outside directors should have called board meeting to challenge management disclosures or should have resigned).

78. *See, e.g.,* 5 U.S.C. § 2301(b)(9) (2000) (federal whistleblower statute); KY. REV. STAT. ANN. § 61.102 (2002) (state whistleblower statute). The California Senate has passed a bill that would require corporate officers to report accounting abuses to the attorney general. Robert Salladay, *"Snitch" Bill Passed by State Senate*, S.F. CHRON., June 21, 2002, at A17.

79. *See Newsmakers*, HOUSTON CHRONICLE, May 22, 2002, at A2. Sherron Watkins honored for disclosing questionable accounting practices at Enron to the Company's Chief Executive Officer, Ken Lay. She did not report the problem to any regulator. *Id*.

80. Sarbanes-Oxley Act of 2002, § 806, Pub. L. No.107-204, 116 Stat. 745.

81. Broker-dealers might be viewed either as gatekeepers or as a part of the SRO structure. Broker-dealers are required to register with the SEC (15 U.S.C. § 78o (2000)) and to supervise their employees (15 U.S.C. §

rass of litigation from these plaintiffs, efforts to curb some of the worst abuses led to the passage of the Private Securities Litigation Reform Act of 1995.[82] Nonetheless, the amount of litigation only increased.[83] Additional pressure was coming from an increasingly active Justice Department that had created special units in several of its U.S. Attorney offices to prosecute securities violators. Sarbanes-Oxley furthers that effort by increasing criminal penalties for violations of the federal securities laws to draconian levels.[84] Another phenomenon of recent years has been the attorney general "wolf packs" that are attacking businesses, including Microsoft and the tobacco compa-

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78o(b)(4)(E), (G)(iii) (2000)). *See also* Bevis Longstreth, *Duty to Supervise is Critical to Effective Self-Regulation*, NAT. L.J., May 16, 1983, at 24. Broker-dealers are also subject to the rules of the exchanges of which they are members and to the rules of NASDR. Adoption of Rules under Section 15(b)(10) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-8135 [1966-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,459, at 82,890 (July 27, 1967).

82. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. The abuses in litigation included the use of "professional plaintiffs" to bring class action lawsuits and the routine filing of lawsuits whenever there was a significant change in the price of a stock. Jordan Eth & Daniel S. Drossman, *The Private Securities Litigation Reform Act: Five Years Young*, 34 Sec. & Commodities Reg. 153, 153 n.3 (July 2001). *See generally* Richard M. Phillips & Gilbert C. Miller, *The Private Securities Litigation Reform Act of 1995: Rebalancing Litigation Risks and Rewards for Class Action Plaintiffs, Defendants and Lawyers*, 51 BUS. LAW. 1009 (1996) (describing abuses). The Private Securities Litigation Reform Act of 1995 was avoided by bringing class actions in state court. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737. The Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, sought to plug that loophole, but another gap was found. *See* Joshua D. Ratner, *Shareholders' Holding Claim Class Actions Under State Law After the Uniform Standards Act of 1998*, 68 U. CHI. L. REV. 1035 (2001).

83. Critics claim that reform efforts to curb abusive litigation have had little effect. *Id. Compare Common Sense Legal Reform Act, Hearings on H.R. 10 Before the Subcomm. on Telecomm. and Fin. of the House Comm. on Commerce*, 104th Cong., 73–86 (1995) (testimony of William S. Lerach, partner, Milberg Weiss Bershad Hynes & Lerach) (statistics suggesting that there was no inordinate increase in the number of class action lawsuits involving securities claims), *with* CORNERSTONE RESEARCH, POST REFORM ACT SECURITITES CASE SETTLEMENTS, 2001: A YEAR IN REVIEW (2002). This study by the Stanford Law School Securities Class Action Clearing House and Cornerstone Research found a 60% increase over 2000 in the number of class actions filed. The companies who were defendants in those actions lost more than $2 trillion in market capitalization after those suits were filed. *Id.*

84. *See* Sarbanes-Oxley Act of 2002, § 1106.

nies, on a national scale, thereby setting their own national regulatory policies.[85]

D. Commodity Futures and Options

Like the securities sector, the regulation of commodity futures trading was cordoned off from other parts of the financial services industry. That decision was again the result of history, rather than the implementation of a measured economic theory of regulatory competition. In response to the agricultural recession that followed World War I, Congress enacted the Futures Trading Act of 1921,[86] which was then declared unconstitutional by the Supreme Court as an impermissible use of the congressional taxing powers.[87] A manipulation of grain prices occurring just a few days after the Supreme Court's decision, however, convinced Congress that regulation was needed,[88] and it passed the Grain Futures Act of 1922[89] under its commerce powers. This legislation was upheld as constitutional by the Supreme Court.[90]

The Grain Futures Act required commodity futures trading to be conducted on organized exchanges, such as the Chicago Board of Trade, which would register with the government as "contract markets."[91] The goal was to stop "bucket shop" opera-

85. *See* Michael Freedman, *Wall Street's Worst Nightmare*, FORBES, Aug. 12, 2002, at 44 (describing tactics of attorney general wolf packs and noting that Alabama securities administrator wants to pursue Wall Street); Russell Gold & Andrew Caffrey, *United Crimebusters*, WALL ST. J., Aug. 1, 2002, at B1 (describing attorney general network). The Connecticut Supreme Court recently held that the state attorney general did not have standing to bring action to correct wrongs wherever they might be found. Blumenthal v. Barnes, 804 A.2d 152 (Conn. 2002). Eliot Spitzer, the New York Attorney General, has been particularly aggressive in attacking businesses in order to garner publicity for himself. *See infra* note 429 and accompanying text.

86. Futures Trading Act, ch. 86, 42 Stat. 187 (1921). This legislation was preceded by an intensive study of the grain markets by the Federal Trade Commission ("FTC"), which found numerous abuses. 1–7 FED. TRADE COMM'N, REPORT OF THE FED. TRADE COMM'N ON THE GRAIN TRADE (1920–1921).

87. Hill v. Wallace, 259 U.S. 44, 71 (1922).

88. H.R. REP. NO. 67-1095, at 2 (1922).

89. Commodity Exchange Act (Grain Futures Act), ch. 369, 42 Stat. 998 (1922) (codified as amended at 7 U.S.C. §§ 1–25 (2000)).

90. Board of Trade v. Olsen, 262 U.S. 1, 42 (1923).

91. Grain Futures Act, ch. 369, §§ 5–7, 42 Stat. 998, 1000 (1922).

tions that were fleecing unsuspecting investors[92] and to provide some regulatory controls that would halt the manipulation of agricultural commodity prices that all too often roiled the markets.[93] The Act was administered by the Grain Futures Administration, an agency within the Department of Agriculture.[94] It proved to be unsuccessful in stopping manipulations or preventing devastation in the agricultural community during the Great Depression, when prices dropped to unprecedented lows.[95]

President Roosevelt added to his call for regulation of the securities markets a request for legislation to regulate the futures markets.[96] History intervened to assure that such regulation

92. Bucket shops accepted customer orders and funds but did not execute the orders on any exchange. Rather, they simply bet the customer would lose and kept the customer's funds in such an event. If the customers won too much, the bucket shop would fold its operations and move to a new location. JOHN HILL, JR., GOLD BRICKS OF SPECULATION 37–39 (1904). The Supreme Court had already provided an effective means for stopping the bucket shops, i.e., shutting off the quotations from the legitimate exchanges on which the bucket shop operators relied for their trading. *See* Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 252–53 (1905) (upholding cutting off quotations to the operations of C.C. Christie, the "Bucket Shop King").

93. Price manipulations were occurring on a monthly basis on the Chicago Board of Trade. *See* Jerry W. Markham, *Manipulation of Commodity Futures Prices — The Unprosecutable Crime*, 8 YALE J. ON REG. 281 (1991) [hereinafter Markham, *Manipulation*]. The traders conducting manipulations became legends. *See* Leon Kendal, *The Chicago Board of Trade and the Federal Government: A Study in their Relationship, 1848 to 1952,* at 56 (Masters Thesis, Ind. U. School of Bus. 1956) (on file with author) ("The feats of Leiter, Armour, Patten, and others in cornering the markets are legends of American commerce.").

94. GEORGE WRIGHT HOFFMAN, FUTURE TRADING UPON ORGANIZED COMMODITY MARKETS IN THE UNITED STATES 372 (1932). The Grain Futures Administration was subject to oversight by a commission composed of the Secretary of Commerce, the Secretary of Agriculture and the Attorney General. Grain Futures Act, ch. 369, § 6, 42 Stat. 998, 1001 (1922).

95. By 1932, wheat prices were at a three-hundred-year low, and a bushel of corn cost less than a pack of chewing gum. *Wheat's Plunge to a 300 Year Low*, THE LITERARY DIGEST, Nov. 12, 1932, at 6.

96. The President's message stated that:

> It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.

would be separately conducted. The agricultural committees in Congress had jurisdiction over the commodity exchanges, while the banking committees controlled securities matters. Neither would cede authority to the other. The agricultural committees acted somewhat more slowly than the banking committees and were unable to pass legislation until 1936. The result, the Commodity Exchange Act of 1936,[97] continued much of the legislative approach of the Grain Futures Act. The name of the Grain Futures Administration was changed to the Commodity Exchange Authority, which was still subject to oversight by the same three cabinet officials ("Commodity Exchange Commission").[98] The analogue to the securities broker-dealer in the commodity futures business is the futures commission merchant ("FCM"). These firms were required to register as such with the government under the Commodity Exchange Act[99] and to segregate customer funds into trust accounts.[100] Option trading was prohibited on regulated commodities.[101]

Manipulation of commodity prices was also prohibited — but that term was not defined in the Commodity Exchange Act of 1936, and the government proved unable to stop such practices.[102] Scandals in commodity options on unregulated commodities in the early 1970s raised concern in Congress,[103] and the incredible inflation in commodity prices during that period

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> I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of *exchanges dealing in securities and commodities* for the protection of investors, for the safeguarding of values, and so far as it may be possible for the elimination of unnecessary, unwise, and destructive speculation.

H.R. REP. NO. 74–421, at 2 (1935) (emphasis added).

97. Commodities Exchange Act of 1936, ch. 545, 49 Stat. 1491 (1936) (codified as amended in scattered sections of 7 U.S.C.).

98. JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 27 (1987) [hereinafter MARKHAM, HISTORY OF COMMODITY FUTURES TRADING].

99. 7 U.S.C. § 6f(a) (2000).

100. 7 U.S.C. § 6d (1990).

101. 7 U.S.C. § 6c(b) (2000).

102. *See* Markham, *Manipulation, supra* note 93, at 313–23 (describing unsuccessful government actions against manipulative activities in the futures markets).

103. *See infra* notes 146–57 and accompanying text.

also led to calls for additional legislation.[104] It came in the form of the Commodity Futures Trading Commission Act of 1974,[105] which carried forward the provisions of the Commodity Exchange Act and created the CFTC. The agency was given exclusive jurisdiction over the trading of commodity futures and commodity options on all commodities.[106] Moreover, the CFTC was given increased enforcement powers,[107] and the regulatory reach of the Commodity Exchange Act was expanded to include commodity trading advisors, commodity pool operators, and associated persons of futures commission merchants.[108]

III. DISTINCTIVE REGULATION DEVELOPS BETWEEN SECURITIES AND FUTURES

During the first forty years of its existence, the SEC found little reason to compete with the Commodity Exchange Authority ("CEA"), as commodity futures and securities operated more or less independently. Indeed, while considering the adoption of the Commodity Exchange Act of 1936, Congress found that some large speculators had transferred their manipulative activities from the stock markets to the grain exchanges in order to escape regulation under the Securities Exchange Act of 1934.[109] SEC Chairman William O. Douglas, therefore, sought further regulation of grain speculators, especially those dealing in puts and calls.[110] President Roosevelt responded by asking his Secretary of Agriculture, Henry Wallace, to take action

104. *See id.*

105. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified in scattered sections of 7 U.S.C.).

106. 7 U.S.C. § 2 (2000).

107. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (codified in scattered sections of 7 U.S.C.).

108. 7 U.S.C. § 6k (2000) (associated person registration requirement); 7 U.S.C. § 6n (2000) (commodity trading advisor and pool operator registration requirement).

109. MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 25. At least one large and vicious speculator crossed over the other way, i.e., from the commodity exchanges to the stock markets during the 1920s. This individual, Arthur Cutten, was involved in numerous commodity manipulations before moving his activities and operating on an even grander scale in the securities markets. *Id.* at 26.

110. *See* 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 143.

against the commodity exchanges.[111] Wallace refused to do so, viewing the SEC's concern as mere pretense, cloaking a power grab by the very ambitious Douglas.[112]

The regulatory structures governing securities and commodity futures were thus allowed to develop separately and distinctively. While the cornerstone of SEC regulation is full disclosure to the public in securities offerings, there is no comparable concept in the Commodity Exchange Act of 1936. The SEC was also given authority to enforce margin requirements for securities set by the Federal Reserve Board, a device Congress concluded would curb speculation and avoid the diversion of scarce credit into such activities.[113] The CEA, on the other hand, possessed no such authority and had informed Congress during the hearings on the Commodity Exchange Act of 1936 that such authority was not needed. Rather, the CEA wanted to impose limits on the amount of trading that could be conducted by the large speculators, who at the time were the principal perpetrators of market manipulations.[114] Such authority was granted by Congress in the Commodity Exchange Act of 1936.[115] The SEC had no comparable power. Although the CEA changed its position not long afterward and sought authority to control margins as well — after its position limits proved ineffective in curbing price rises in commodity markets — Congress refused to grant the CEA this power.[116] Margins on futures were considered a

111. *Id.*

112. *Id.* at 225.

113. 15 U.S.C. § 78g (2000). Margin requirements are set under Federal Reserve Board Rules, the most prominent of which is Regulation T. Credit by Brokers and Dealers, 12 C.F.R. §§ 220.1–220.18 (2002). The Federal Reserve Board changed margin requirements some twenty-five times after the adoption of the Securities Exchange Act of 1934 in order to squelch speculation in the case of increases or to ease access to the market during downturns. Today, most actively traded stock is subject to a margin requirement of 50%. 23 MARKHAM & HAZEN, *supra* note 35, §§ 3.01–3.02.

114. *See* Jerry W. Markham, *Federal Regulation of Margin in the Commodity Futures Industry — History and Theory*, 64 TEMP. L. REV. 59, 69–71, 71 n.60 (1991) [hereinafter Markham, *Federal Regulation of Margin*].

115. *See* 7 U.S.C. § 6a(c) (2000) (authorizing position limits for speculators and exempting "bona fide" hedging from their application). *See also generally* United States v. Cohen, 448 F.2d 1224 (2d Cir. 1971) (speculative limit violations); Kent v. Hardin, 425 F.2d 1346 (5th Cir. 1970); Goodman v. Benson, 286 F.2d 896 (7th Cir. 1961).

116. Markham, *Federal Regulation of Margin*, *supra* note 114, at 71–80.

device to protect the exchanges and futures commission merchants from customer defaults, rather than a credit allocation issue or a means to control speculation.[117] Congress thought that the commodity exchanges were in a better position than the government to assure that margin levels were adequate for their protection.[118]

Although both agencies had antifraud provisions to administer, the Commodity Exchange Act provision was more narrowly focused and was never given the expansive interpretation applied to Section 10(b) of the Securities Exchange Act of 1934.[119] That section was the most broadly applied of the antifraud provisions administered by the SEC; it was pursuant to that section that the SEC adopted Rule 10b-5.[120] The rule applies to all securities transactions, and the SEC has used this authority to create entire regulatory programs, the most famous being its insider trading prosecutions.[121] Demonstrating the flexibility of Rule 10b-5, the SEC's insider trading program was not begun until over a quarter of a century after the agency was created, and almost twenty years after the adoption of the rule.[122] Although sometimes likened to Section 10(b) of the Securities Exchange Act of 1934, Section 4b of the Commodity Exchange Act of 1936[123] was limited to specific fraudulent practices made in

117. *Id.*

118. *Id.* at 76. This did not stop the government from jawboning and threatening the commodity exchanges with more regulation if they did not increase margins during periods of major price increases. *Id.* at 80.

119. 15 U.S.C. § 78j(b) (2000).

120. Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2002).

121. 2 HAZEN TREATISE, *supra* note 51, § 12.3[2] (describing adoption and expansion of the application of Rule 10b-5). The SEC has not been shy in creating substantive regulation through litigation in other areas, such as questionable payments to foreign government officials in order to obtain business. ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 153–159 (1982).

122. Rule 10b-5 was adopted in 1942. Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2002). The SEC did not prosecute insider trading under this rule until 1961. *See* In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961). Even then, Rule 10b-5 did not receive much attention for insider trading purposes for another seven years, when it was given its most expansive interpretation in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied, sub nom.*, Coates v. SEC, 394 U.S. 976 (1969).

123. 7 U.S.C. § 6b (2000).

connection with futures traded on contract markets.[124] There was no interest by commodity regulators in creating an insider trading program in the futures industry.[125]

Additional disparities existed in the two regulatory schemes. A cornerstone of SEC broker-dealer regulation became the suitability requirement, i.e., a broker-dealer may not recommend securities to a customer that are unsuitable in light of the customer's own particular financial circumstances and objectives[126] — a doctrine that the SEC created out of whole cloth.[127] The CEA, on the other hand, invented no comparable regulatory concept. The Commodity Exchange Act of 1936 prohibited over-the-counter dealings in commodity futures; the contract markets were given a monopoly on such transactions, at least

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124. The Supreme Court has casually compared Section 4b in the Commodity Exchange Act with Section 10(b) of the Securities Exchange Act of 1934. *See* Merrill Lynch, Pierce Fenner & Smith Inc. v. Curran, 456 U.S. 353 (1982). But in fact, the language and application of Section 4b has been more narrowly focused, i.e., it applies only to commodity futures trading on contract markets. *See* 13 JERRY W. MARKHAM, COMMODITIES REGULATION: FRAUD, MANIPULATION & OTHER CLAIMS §§ 1.01–1.08 (2001) [hereinafter MARKHAM, FRAUD, MANIPULATION & OTHER CLAIMS] (describing judicial decisions interpreting Section 4b). The CFTC did adopt antifraud rules for other products such as commodity options (17 C.F.R. § 32.9 (2002)), foreign futures contracts, (17 C.F.R. § 30.9 (2002)), and leverage contracts, Fraud in Connection with Certain Transaction in Silver or Gold Bullion or Bulk Coins, or Other Commodities, 17 C.F.R. § 31.3 (2002). The CFTC had tried to model its commodity options rule after SEC Rule 10b-5, but was forced to retreat in the face of industry opposition. The CFTC did keep Rule 10b-5 language in its antifraud rule for leverage contracts. 13 MARKHAM, FRAUD, MANIPULATION & OTHER CLAIMS, *supra,* § 2.08.

125. *See* discussion *infra* notes 169–71 and accompanying text.

126. *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557 (1999) (describing suitability doctrine).

127. The suitability doctrine was borrowed from the NYSE's "know your customer" rule. The exchange rule sought to protect member firms from unscrupulous "freeriding" customers that bought stock and paid only if the stock price increased. The SEC turned that concept on its head and imposed the suitability obligation on broker-dealers as a customer protection measure. This was done under the SEC's "shingle" theory, which posits that, in hanging out its shingle, a broker-dealer represents to the public that the broker-dealer is a professional and customers may rely on that expertise for suitable recommendations. *See generally* 23A MARKHAM & HAZEN, *supra* note 35, § 9.01 (describing basis of suitability doctrine).

for the "regulated" commodities.[128] The SEC, in contrast, regulated a broad-based over-the-counter market[129] and imposed affirmative obligations on market makers and exchange specialists to make a "fair and orderly" market, i.e., a market that was not volatile.[130] No such requirement was imposed on the floor traders on the commodity exchanges. Instead, trading was conducted in an auction-style open outcry system in which traders could participate, or not, as they chose.[131]

SEC regulation was paternalistic in other ways. It imposed a duty of supervision on broker-dealers that required them to affirmatively supervise their employees with a view toward preventing violations.[132] The CEA, in contrast, imposed no such obligation on futures commission merchants.[133] However, the

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128. 7 U.S.C. § 7 (2000). *See generally* Jerry W. Markham, *The Commodity Exchange Monopoly — Reform is Needed,* 48 WASH. & LEE L. REV. 977 (1991) [hereinafter Markham, *The Commodity Exchange Monopoly*] (describing ill effects of the commodity exchange trading requirement).

129. This is not to suggest that the SEC was without sin. It allowed the NYSE to enforce a rule against its members that prohibited trading of listed stocks except through the exchange. This gave rise to the "third" and "fourth" markets in listed stocks by non-members. The SEC tried to hack away at the rule by prohibiting its application to trading on other exchanges and then to newly listed securities. Finally, the NYSE capitulated and repealed the rule in 1999. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 332.

130. 15 U.S.C. § 78k(b) (2000). *See* Shultz v. SEC, 614 F.2d 561, 563–64 (7th Cir. 1980) (describing market-making obligations). The Nasdaq market uses competitive market makers, while the stock exchanges use the specialist, but both have affirmative market-stabilizing obligations. 23A MARKHAM & HAZEN, *supra* note 35, § 10.01 (describing market making obligations).

131. *See* Markham, *Manipulation, supra* note 93, at 363–76 (comparing market-making obligations on commodity and security exchanges). Block positioning was encouraged in the securities industry, but was prohibited in the futures markets. *Id*. at 374.

132. *See generally* Lewis D. Lowenfels & Alan R. Bromberg, *Broker-Dealer Supervision: A Troublesome Area*, 25 SETON HALL L. REV. 527 (1994) (describing supervisory duty).

133. The Commodity Exchange Act of 1936 did impose liability on futures commission merchants for the acts of their agents. 7 U.S.C. § 2a (2000). There was no comparable provision in the federal securities laws, but the SEC claimed that such liability was appropriate even without authorizing legislation. *Compare* Hollinger v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990) (overruling *en banc* an earlier decision that had rejected *respondeat superior* liability) *and* Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967) (rejecting agency liability), *with, e.g.*, Fey v. Walston & Co., 493 F.2d 1036 (7th Cir. 1974) (applying *respondeat superior* liability). The SEC did have the authority to sanction controlling persons. 15 U.S.C. § 78t(a); 15 U.S.C. § 77o (2000). That

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CEA did have a large trader reporting system, a power that the SEC did not receive until 1990.[134] The CEA required large traders to file a report disclosing the identity of the trader and any affiliates or entities under common control. The size of the trader's position was then monitored by the CEA to assure that the trader posed no danger to the market.[135]

Though the securities and commodity futures regulatory schemes differed, no one really noticed before the 1970s. The product mix of the two industries was such that, aside from some mobile speculators, there was little overlap between commodity and futures trading.[136] The situation began to change dramatically as inflation heated the economy during the Vietnam War.[137] The resulting price hikes turned investors' attention toward inflation hedges such as gold and silver. The removal of restrictions on trading allowed these metals to be the subject of commodity futures trading. Similarly, President Nixon's removal of the U.S. from the gold standard and out of the International Monetary Fund's fixed rate currency regime led to fluctuating exchange rates that provided a basis for currency trading.[138]

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power was not added to the Commodity Exchange Act until 1982. 7 U.S.C § 13c(b) (2000).

134. This authority was given to the SEC by the Market Reform Act of 1990, § 3, Pub. L. No. 101-432, 104 Stat. 963 (amending 15 U.S.C. § 78m(h)). The SEC proposed a rule implementing this authority. *See* Large Trader Reporting System, Exchange Act Release No. 34-33,608, 59 Fed. Reg. 7917 (Feb. 17, 1994). However, it has not been adopted.

135. *See generally* In the Matter of International Futures Corp., Comm. Fut. L. Rep. (CCH) ¶ 27,993 (C.F.T.C. 2000) describing prior violations of CEA large trader reporting requirements), *aff'd, without opinion*, Commodity Futures Trading Comm'n v. Hunt, 559 F.2d 1224 (7th Cir. 1977).

136. Broker-dealers engaging in securities activities often had separate departments that conducted commodity futures trading for customers. This required dual registration under the Commodity Exchange Act of 1936 and the Securities Exchange Act of 1934.

137. The inflation that occurred in the 1970s led to many "hard" money investment programs that would inflate with the economy. *See* 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 61 (describing these programs).

138. *See generally* LEO MELAMED & BOB TAMARKIN, ESCAPE TO THE FUTURES (1996) (describing creation of futures markets on currency).

Price volatility also led the commodity exchanges to consider commodity futures trading on interest rates and stock prices.[139] A committee of the Chicago Board of Trade began to explore whether commodity futures trading principles could be applied to stocks. The result was the CBOE.[140] Prior to the creation of the CBOE, stock options were sold only on a limited basis in the over-the-counter market. The CBOE introduced a commodity futures concept of trading standardized options contracts on an exchange floor. This standardization, along with the introduction of a clearing house, the Options Clearing Corporation ("OCC"), created a secondary market in options. The CBOE trading floor borrowed from both the securities and commodity exchanges. Instead of a specialist, competing market makers were used to create liquidity in an open outcry system like that on the commodity exchanges.[141]

The SEC asserted regulatory control over the CBOE under the provisions of the Securities Exchange Act of 1934,[142] and also became involved in the regulation of over-the-counter commodity options. A loophole in the Commodity Exchange Act of 1936 allowed options trading on "unregulated" commodities, such as sugar, coffee, and silver. Harold Goldstein, a twenty-six year old commodity trader discovered this and built one of the largest brokerage firms almost overnight through the sale of "naked" options, not backed by anything other than the dubious credit of Goldstein's firm, Goldstein, Samuelson. However, increasing prices resulted in customer gains that Goldstein could not cover. The SEC shut down his and similar options firms by claiming that these contracts were securities.[143] State securities

139. For a description of these events, see 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 42–43.

140. Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137, 1140 n.2 (7th Cir. 1982), *vacated as moot*, 459 U.S. 1026 (1982).

141. *See* Markham & Gilberg, *supra* note 43, at 743–45 (describing the CBOE trading system).

142. 15 U.S.C. § 78i(b) (2000). A court later noted that, if the CFTC had been in existence when the CBOE was created, the CFTC, rather than the SEC, would have had jurisdiction. *Board of Trade of the City of Chicago*, 677 F.2d at 1140 n.2.

143. *See, e.g.*, SEC v. Commodity Options Int'l, Inc., 553 F.2d 628 (9th Cir. 1977); SEC v. American Commodity Options Exch., Inc., 546 F.2d 1361 (10th Cir. 1976).

administrators aided the SEC in these efforts, and Goldstein was finally jailed.[144]

The Goldstein, Samuelson debacle caused concern in Congress, as did the large jump in commodity prices during this period.[145] Congressional hearings found fault with the CEA's deference to the commodity exchanges,[146] and Congress concluded that new legislation was needed to close the regulatory gap in the Commodity Exchange Act that had allowed Goldstein, Samuelson to operate. Congress thought that all commodity options and futures trading should be subject to regulation,[147] and thus the Commodity Futures Trading Commission Act of 1974 ("CFTCA") created the CFTC[148] and brought all commodity futures and options trading under a "single regulatory umbrella."[149] The CFTC was "patterned" after the SEC and was granted strengthened enforcement powers,[150] including authority to seek injunctive relief,[151] a favorite weapon employed

144. *See generally* Robert C. Lower, *The Regulation of Commodity Options*, 1978 DUKE L.J. 1095 (1978) (describing Goldstein's operations and resulting regulation); Note, *The Role of the Commodity Futures Trading Commission Under The Commodity Futures Trading Commission Act of 1974*, 73 MICH. L. REV. 710, 721 n.8 (1975) (describing losses).

145. Soybean prices increased by over $8 per bushel in one five-month period. MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 56–57. A large sale of grain to the Soviet Union caused a spike in wheat prices and led to claims that the Soviets and various grain companies had profited on those transactions by advance purchases on the futures markets — the "Great Grain Robbery." DAN MORGAN, MERCHANTS OF GRAIN 12–121 (1979) (observing that the grain robbery was a world-changing economic event).

146. MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 60–65.

147. The Commodity Exchange Act of 1936 regulated futures trading only on specified commodities. Additional commodities were added to that list over the years, but such *ad hoc* amendments could not keep pace with the continual expansion of futures trading to other commodities.

148. Commodity Futures Trading Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (amending 7 U.S.C. §§ 2, 4).

149. H.R. REP. NO. 93-975 at 42 (1974).

150. 120 CONG. REC. 30467 (1974) (remarks of Sen. Taft). The CFTC was to be comparable to the SEC in its regulatory role. *See generally* S. REP. NO. 93-1131 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843; 120 CONG. REC. 10741 (1974) (remarks of Rep. Adams).

151. Commodity Exchange Act, 7 U.S.C. § 13a-1 (2000). The CEA had sought such authority in 1968, but the authorizing legislation was blocked in Congress by the commodity exchanges. Jerry W. Markham, *Injunctive Ac-*

by the SEC.[152] Self-regulation by the commodity exchanges was also strengthened.[153] The National Futures Association was later created to act as an analogue to the NASD.

The CFTCA further gave the CFTC certain authority that the SEC did not possess: the CFTC could impose civil penalties of up to $100,000 per violation[154] (a power that the SEC did not receive until 1984),[155] bar violators from trading on contract markets[156] (a power that the SEC was not given), and grant reparations to investors injured by violations committed by registered persons (again, this was not a power granted to the SEC).[157]

There were other differences in regulation between the two agencies. Congress passed the Securities Investor Protection Act ("SIPA") in 1970,[158] after the securities industry nearly collapsed during the "paperwork crisis" at the end of the 1970s.[159]

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tions under the Commodity Exchange Act, Sec. Reg. & L. Rep. (BNA) No. 504, at B-1 (May 23, 1979).

152. *See generally* Harvey L. Pitt and Jerry W. Markham, *SEC Civil Injunctive Actions: A Reply*, 6 REV. SEC. REG. 955 (1973) (describing importance of injunctive actions in SEC enforcement program). Professor Karmel has charged that the SEC has used its injunctive actions, which often end in consent decrees, to create substantive regulation. *See generally* KARMEL, *supra* note 121. Interestingly, the CFTC rarely brings injunctive actions and instead prefers to initiate administrative disciplinary proceedings.

153. Jerry W. Markham & John M. Schobel, *Self-Regulation Under the Commodity Exchange Act — Can the CFTC Make It Work?,* Sec. Reg. & L. Rep. (BNA) No. 368 (Special Supp. Sept. 1, 1976).

154. Commodity Exchange Act, 7 U.S.C. § 9 (2000).

155. The SEC was given the power to seek civil penalties for insider trading by the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

156. 7 U.S.C. § 9 (2000).

157. 7 U.S.C. § 18 (2000). *See generally* William R. Schief & Jerry W. Markham, *The Nation's "Commodity Cops" — Efforts by the Commodity Futures Trading Commission to Enforce the Commodity Exchange Act*, 34 BUS. LAW. 19 (1978) (describing CFTC enforcement powers and actions); Jerry W. Markham, *The Seventh Amendment and CFTC Reparations Proceedings*, 68 IOWA L. REV. 87 (1982) (describing CFTC reparations proceedings).

158. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (codified as amended at 15 U.S.C. §§ 78o, 78aaa–78lll (2000)). *See also* sources cited *supra* note 36; Securities Investor Protection Corp. v. Barbour, 421 U.S. 412 (1975) (describing this statute).

159. NYSE firms were choking on daily trading volume averaging 16 million shares at the end of the 1960s. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 361. Today, the NYSE is able to handle daily volume of 2.8 billion shares without a hiccup. Adam Shell, *Have Stocks Finally Hit Bot-*

The statute provided insurance to securities customers (now $500,000, of which up to $100,000 may be in cash) in the event of a broker-dealer insolvency.[160] The CFTCA also directed the CFTC to consider whether such legislation was needed in the futures industry.[161] The resulting CFTC study compared loss ratios of firms under government insurance programs with the loss ratios of commodity futures customers. The loss ratios for futures commission merchant customers were found to be substantially lower than insured firms, leading the CFTC to conclude that insurance was unnecessary.[162]

This is a marked difference in competing regulatory approaches. Insurance creates a moral hazard that the firm being insured will attract funds at low cost from investors on the strength of the government's credit and then use those funds for high return, high risk ventures. The savings and loan debacle of the 1980s is a good example of a gluttonous feast on insured funds.[163] The futures industry, in contrast, uses market discipline to protect customers, which seems an unlikely undertaking when the nature of futures trading is considered. Commodity futures contracts are highly leveraged. The low margin requirements set by the exchanges are only a very small percent of the notional amount at risk.[164] Small moves mean large losses to at least half of the market participants.[165] Futures

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tom?, USA TODAY, July 25, 2002, at 1B. During the "paperwork crisis," some 160 NYSE firms failed, and the exchange exhausted the trust fund it had used to indemnify customers in failed firms. SELIGMAN, *supra* note 32, at 452–53.

160. Securities Investor Protection Act of 1970, 15 U.S.C. § 78fff-3 (2000).

161. Commodity Futures Trading Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (amending 7 U.S.C. §§ 2, 4).

162. Report to the Congress Concerning Commodity Futures Account Insurance, Comm. Fut. L. Rep. (CCH) ¶ 20,235 (Nov. 1, 1976).

163. *See generally* BANKING SCANDALS: THE S & LS AND BCCI (Robert Emmet Long ed., 1993) (describing the looting that went on in the savings and loan industry); Spiegel v. Ryan, 946 F.2d 1435 (9th Cir. 1991), *cert. denied*, 503 U.S. 970 (1992) (describing the looting that went on at Columbia Savings & Loan Association).

164. SEC v. Commodity Options Int'l, Inc., 553 F.2d 628, 629 (9th Cir. 1977).

165. Futures trading is a zero-sum game. For each buyer, there is a seller. A market move one way or the other will mean a gain to one side and a loss to the other. Board of Trade v. CFTC, 724 F. Supp. 548, 555 n.11 (N.D. Ill. 1989). The loss may be offset by another risk, however, as in the case of a hedger. *See* Merrill Lynch, Pierce Fenner & Smith Inc. v. Curran, 456 U.S. 353, n.11 (1982) (describing hedging with commodity futures).

contracts are also selected on the basis of a high degree of price volatility, and speculation is encouraged.[166] Yet, despite the leverage (and attendant risk) and the large element of speculation present, there are fewer customer losses due to the bankruptcy of a financial intermediary than in the insured industries that have less risk, volatility, and speculation.[167]

The answer lies in the way margin trading is regulated in the futures industry. The exchanges set margin for the protection of their clearing houses and positions are marked to market daily. Losses must be recognized through variation margin payments that must be made before the firm can trade the next day. Futures commission merchants are thus forced to recognize customer losses each day. Losses cannot be put off in the hope of a market recovery;[168] nor can they accumulate.[169] The

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166. Speculation provides price information and liquidity for hedgers offsetting commercial risks through the futures markets. *Curran*, 456 U.S. at 358–60.

167. From 1970 to at least 1996, no failure of member of a major commodity futures exchange resulted in a loss of customer funds. Jerry W. Markham, *The CFTC Net Capital Rule — Should a More Risk-Based Approach be Adopted?*, 71 CHI.-KENT L. REV. 1091, 1093 (1996) [hereinafter Markham, *The CFTC Net Capital Rule*].

168. As noted by one exchange official:

> This unique feature is a primary factor which enables commodity markets to boast an incredibly good record in the area of insolvencies. Every firm must be monetarily "even" with the commodity prices of the previous day. If a firm's net commitment shows a net loss on the basis of the previous settlement prices, it pays the resultant amount to the exchange clearinghouse. If a firm's net commitment shows a profit, it collects the resultant amount from the clearinghouse. This process is a daily procedure.

Review of the Commodity Exchange Act and Discussion of Possible Changes: Hearings Before the House Comm. on Agriculture, 93d Cong. 192 (1973) (statement of Leo Melamed, Secretary of the Board, Chicago Mercantile Exchange).

169. This is not to say that there have been no failures of futures commission merchants. Large customer losses have occurred as the result of looting of customer accounts to pay margins for accounts in deficit. Three of the more highly publicized of those failures occurred in the early 1980s: Incomco, Inc.; Chicago Discount Commodity Brokers; and Volume Investors. The latter failure led the CFTC staff to reconsider whether account insurance was needed, but no action was taken. At the time, customer losses from bankrupt futures commission merchants were averaging only about $2 million per year. 23 MARKHAM & HAZEN, *supra* note 35, § 4.08. The tenth largest futures commission merchant failed in 1990. *See* In re Stotler & Co., 144 B.R. 385, 386 (N.D

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securities industry, on the other hand, had no comparable market discipline. Transactions were settled on a T+5 basis, i.e., settlement was not made until five days after the execution of the trade. This left plenty of time for losses to mount or for customers to engage in reckless conduct to make up for losses. The SEC has since imposed a T+3 requirement on settlement, but this is still three days more than is required in the futures industry.[170]

At the time the CFTC was created, the SEC was also in the midst of defending an expansive interpretation of its insider trading program under Rule 10b-5. The CFTC later conducted a study to determine whether a similar rule was needed in the futures industry,[171] but concluded it was not appropriate to impose such a regulation on futures traders.[172] Many participants in the futures markets had superior access to information and traders on exchange floors had time and place advantages for the use of information. The CFTC believed that it was neither

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Ill. 1992) (describing size of bankruptcy). That firm, Stotler & Co., was headed by the Chairman of the Chicago Board of Trade. The parent company had moved several millions of dollars out of the futures commission merchant before it failed. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 162–63. Customer losses, however, appear to have been minimal. *See In re Stotler*, 144 B.R. at 386.

170. *See generally* Report of the Backmann Task Force on Clearance and Settlement Reform in U.S. Securities Markets, Exchange Act Release No. 30,802, 51 S.E.C. Docket 1,073 (June 15, 1992) (describing need for reducing settlement period); Securities Transactions Settlement, Exchange Act Release No. 34-33,023, 58 Fed. Reg. 52,891 (Oct. 13, 1993) (adopting T+3 requirement). An SEC chairman subsequently suggested that T+1 or even same day settlement should be the securities industry goal. SEC Chairman Arthur Levitt, *Speeding Up Settlement; The Next Frontier*, Address Before a Symposium on Risk Reduction and Payments, Clearance and Settlement Systems, New York, NY, Jan. 26, 1996.

171. CFTC, *A Study of the Nature, Extent and Effects of Futures Trading by Persons Possessing Material Nonpublic Information, submitted to the House Committee on Agriculture and Senate Committee on Agriculture, Nutrition and Forestry Pursuant to Section 23(b) of the Commodity Exchange Act, as Amended* (Sept. 1984) (on file with author) [hereinafter CFTC, *Study of the Nature, Extent and Effects of Futures Trading*].

172. *Id.* The author leaves for others to resolve the debate whether insider trading in securities is good or bad. *See* Henry G. Manne, *Options? Nah. Try Insider Trading*, WALL ST. J., Aug. 2, 2002, at A8 (advocating using inside information as a form of compensation and asserting that: "Currently, the SEC sees its job as regulating the entire market for information. This is madness.").

practical nor desirable to mandate that traders have equal access to information, as required by the SEC.[173]

The CFTC did seek to adopt some regulatory requirements that would have more closely conformed its regulatory structure to that of the SEC, largely due to the fact that several newly arrived staff members at the CFTC had formerly served on the SEC staff.[174] One SEC-style proposal enacted was a net capital rule.[175] The SEC had adopted its Uniform Net Capital Rule in the aftermath of the paperwork crisis.[176] Since the stock exchanges had failed to enforce their capital rules during the paperwork crisis,[177] the SEC concluded that a more stringent federal rule was needed to protect customers and the SIPA insur-

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173. The CFTC viewed most information used for futures trading to be "market" information that, at least in theory, was accessible to everyone, even if not on an equal basis. The CFTC did express concern regarding abuses of information obtained by the exchanges in confidence that could be traded for a profit. The CFTC adopted a rule to guard against such abuses (17 C.F.R. § 1.59 (2002)), and the Commodity Exchange Act was later amended to include such a prohibition. *See* H.R. REP. NO. 102–978, at 23 (1992) (discussing the amendment). The CFTC initially rejected the "misappropriation" theory that the SEC was pushing in the securities industry. *Compare*, CFTC, *Study of the Nature, Extent and Effects of Futures Trading*, *supra* note 171, at 57, *with*, United States v. O'Hagan, 521 U.S. 642 (1997) (endorsing SEC misappropriation theory). The CFTC, however, later brought a case against two traders who were misappropriating information concerning the trading plans of a large firm that had market effect. Commodity Futures Trading Comm'n v. Kelly, Comm. Fut. L. Rep. (CCH) ¶ 27,465 (S.D.N.Y. 1998).

174. *See* MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 86 (describing staff members that drafted CFTC net capital rule). (The author must confess to being one of these staff members.)

175. Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers, 17 C.F.R. § 1.17 (2002).

176. Net Capital Requirements for Brokers and Dealers, 17 C.F.R. § 240.15c3-1 (2002). Government insurance programs inevitably lead to pervasive and intrusive, as well as very expensive and complex, regulation — all of which is justified as necessary to protect the insurance fund because market discipline has been removed.

177. The Chairman of the NYSE stated that another one hundred exchange member firms would have been put out of business if the exchange had strictly enforced its capital rule during the paperwork crisis. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 364. In contrast, the Chicago Board of Trade suspended the firm of Hayden, Stone for failing to meet its capital requirements. The NYSE then pressured the Board of Trade to remove the suspension in order to prevent a failure of the firm, which was also a member of the NYSE. Hayden, Stone continued to encounter difficulties. *Id.* at 363.

ance fund.[178] The futures industry had no paperwork crisis — its overnight settlement requirement and paperless trading assured that result.[179] Nevertheless, the newly arrived SEC staff members were fresh from their exposure to the SEC Uniform Net Capital Rule, and believed such a requirement was needed.[180] Still, the CFTC net capital rule does not appear to have had much effect in preventing insolvencies by futures commission merchants. If anything, the traditionally low rate of failures actually increased.[181] The CFTC net capital rule is also flawed and out of date in its risk measurement criteria,[182] but still remains on the books.

The CFTC staff also tried to borrow wholesale from the SEC's rulebook[183] by proposing a set of customer protection rules.[184]

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178. The SEC's capital rule did not apply to exchange member firms until the adoption of its Uniform Net Capital Rule in 1975. Under the old rule, stock exchange member firms were subject to capital requirements imposed by the exchanges. 23A MARKHAM & HAZEN, *supra* note 35, § 5.02. For a description of the background and reasons for the adoption of the Uniform Net Capital Rule, see generally SEC, STUDY OF UNSAFE AND UNSOUND PRACTICES OF BROKER-DEALERS, H.R. DOC. NO. 92-231 (1971).

179. In 1968, Congress added the authority to adopt capital rules to the Commodity Exchange Act of 1936 due to concern that irresponsible firms were entering the business. Commodities Exchange Act of 1936, amended by 82 Stat. 26 (1968). *See generally* S. REP. NO. 90-947 (1968), *reprinted in* 1968 U.S.C.C.A.N. 1673.

180. *See generally* Proposed Financial Reporting Requirements for Futures Commission Merchants, Comm. Fut. L. Rep. (CCH) ¶ 20,220 (Oct. 15, 1976) (describing proposed CFTC net capital rule).

181. *See supra* note 169 (describing failures by futures commission merchants on the CFTC's watch).

182. *See* Markham, *The CFTC Net Capital Rule*, *supra* note 167, at 1091 (describing flaws in CFTC net capital rule).

183. Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers, 17 C.F.R. § 1.17 (2002). There has been some cross-fertilization from the CFTC to the SEC. As another measure to protect the SIPA insurance fund, the SEC was directed by Congress to adopt rules for the protection of customer funds. 15 U.S.C. § 78o(c)(3)(A) (2000). The SEC adopted its "Customer Protection Rule" in response. 17 C.F.R. § 240.15c3-3 (2002). This rule requires customer funds held by broker-dealers to be kept in special bank accounts held for the benefit of customers. Box counts of customer funds and securities are also required. *Id.* The rule was adopted in the wake of the paperwork crisis and after criticism was raised that customer free credit balances were being used to fund the operations of broker-dealers, effectively an interest-free loan. 23A MARKHAM & HAZEN, *supra* note 35, § 4.03. The SEC Customer Protection Rule was directly analogous to the requirement in the Commodity Exchange Act of 1936 on segregation of customer funds and

Among other things, the proposals included a rule imposing a supervision requirement like that employed by the SEC. The rule was adopted, albeit in a more simplified form.[185] A proposal to adopt a suitability requirement did not fare as well[186] — it set off a firestorm of controversy and the rule was never adopted.[187] Instead, the CFTC adopted a one-page risk disclosure statement that advised customers of the risks of trading commodity futures, and recommended that customers should themselves consider whether commodity futures trading was suitable in light of their particular circumstances and financial resources.[188] Customers were required to sign the statement and

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securities into special bank accounts. 7 U.S.C. § 6d (2000). *See also* Customer Funds to be Segregated and Separately Accounted For, 17 C.F.R. § 1.20 (2002) (regulation implementing segregation requirements).

The SEC stated that it was hopeful that its Customer Protection Rule would obviate the need for its net capital rule. SECURITIES EXCHANGE COMMISSION, STUDY ON THE FINANCING AND REGULATORY CAPITAL NEEDS OF THE SECURITIES INDUSTRY 7 n.17 (Jan. 23, 1985) (on file with author). Government being what it is, that never came to pass.

184. *See generally* Protection of Commodity Customers: Standards of Conduct for Commodity Trading Professionals, 42 Fed. Reg. 44,742 (1977).

185. 17 C.F.R. § 166.3 (2002). *See generally* Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886 (1978). (As the result of much industry opposition, the proposed supervisory rule was simplified before adoption.)

186. Protection of Commodity Customers: Standards of Conduct for Commodity Trading Professionals, 42 Fed. Reg. 44,742, 44,743 (1977).

187. The CFTC asserted that such a requirement was implied in the Commodity Exchange Act of 1936, and, therefore, a rule was not needed. Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886, 31,889 (1978). After some flip-flopping, the CFTC later held in its reparations proceedings that there is no suitability requirement in the act. Phacelli v. Conticommodity Services, Inc., Comm. Fut. L. Rep. (CCH) ¶ 22,345 (C.F.T.C. 1984). The courts agreed with that interpretation. *See, e.g.*, Schofield v. First Commodity Corp., 793 F.2d 28 (1st Cir. 1986).

The CFTC had also proposed a churning rule that would have prohibited brokers from excessively trading customer accounts they controlled. Protection of Commodity Customers: Standards of Conduct for Commodity Trading Professionals, 42 Fed. Reg. 44,742, 44,745 (1977). This proposal was also dropped. Like the suitability proposal, the CFTC claimed that such a requirement was already implied in the Commodity Exchange Act of 1936. Adoption of Customer Protection Rules, 43 Fed. Reg. 31,886, 31,889 (1978). Unlike the suitability rule, the CFTC later held that the CEA antifraud provision implied a churning prohibition. *See, e.g.*, In re Lincolnwood Commodities, Inc., Comm. Fut. L. Rep. (CCH) ¶ 21,986 (C.F.T.C. 1984).

188. Distribution of "Risk Disclosure Statement" by Futures Commission Merchants and Introducing Brokers, 17 C.F.R. § 1.55 (2002).

confirm that they had read and understood the risks.[189] This was visibly different from the paternalistic approach of the SEC — the CFTC was requiring individuals to take responsibility for their own investment decisions. Regulatory competition was indeed influencing the manner in which the two industries would be regulated. This competition would also lead to much strife.

IV. REGULATORY BATTLES BETWEEN CFTC AND SEC

The SEC was not new to regulatory competition when the CFTC arrived, and had just recently engaged in an extended quarrel with the banking regulators over which it should have been given authority to regulate securities clearing and settlement functions conducted by banks.[190] That slanging match ended in a compromise whereby regulatory authority over banks engaging in clearing and settlement was given to the bank regulatory authorities, while the SEC regulated all others.[191] In another act of aggression, the SEC adopted a rule that would have subjected banks engaging in securities activities to registration as broker-dealers under the Securities Exchange Act of 1934. However, a circuit court struck down the rule as being outside the SEC's jurisdiction.[192] Nonetheless, the SEC continued to seek to regulate banks through the back door of disclosure, i.e., most large banks are public companies that must report to the SEC.[193]

The SEC soon found itself on the defensive as bank regulators took an increasingly liberal view of which activities banks could

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189. *Id.*

190. The SEC claimed before Congress that it had greater enforcement powers than the bank regulators and thus should be given sole jurisdiction over all clearing and settlement activities, including those by banks. The banks took umbrage and fought back in Congress with their own expansive claims of regulatory authority. *See* 23A MARKHAM & HAZEN, *supra* note 35, § 8.02.

191. *Id.* A similar compromise was reached in 1985 over the regulation of dealers in government securities. 3 HAZEN TREATISE, *supra* note 51, § 14.7 (describing Government Securities Act of 1986).

192. American Bankers Ass'n v. SEC, 804 F.2d 739 (D.C. Cir. 1986).

193. Raphael Soifer, *U.S. Regulator Applies the Pressure*, 151 BANKER, Issue No. 902, Apr. 1, 2001.

engage in under the Glass-Steagall Act.[194] The securities industry retaliated through the courts, with mixed success. Furthermore, competition between the CFTC and the SEC was another challenge that began almost immediately after the adoption of the CFTCA. The decision of the CFTC to approve commodity futures trading on Government National Mortgage Association ("GNMA") certificates set off an explosion at the SEC. The SEC contended that such contracts were the equivalent of "when issued" GNMAs that were already regulated by the SEC. This resulted in an exchange of acrimonious correspondence between the two agencies. At the end of the day, the SEC lost the battle and GNMA futures continued to trade.[195] Undaunted, the CFTC also approved a futures contract on treasury bills on the Chicago Mercantile Exchange in 1976.[196] The SEC, however, had a long memory and, as will be seen, would retaliate against the CFTC.[197]

In the meantime, the grant of exclusive jurisdiction to the CFTC over commodity options[198] removed the regulatory controls established by the SEC and state securities administrators over commodity option dealers.[199] The results were a quick return of fly-by-night commodity option firms, numerous scandals, and widespread fraud. The situation was not alleviated until the CFTC suspended the trading of commodity options,[200]

194. *See generally* MICHAEL G. CAPATIDES, A GUIDE TO THE CAPITAL MARKETS ACTIVITIES OF BANKS AND BANK HOLDING COMPANIES (1993) (describing expansion of bank activities).

195. *See* MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 81–83 (describing this dispute).

196. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 81.

197. *See infra* note 208 and accompanying text.

198. Commodity Exchange Act, 7 U.S.C. § 2a(ii) (2000).

199. *See* John M. Schobel, Jr. & Jerry W. Markham, *Commodity Options — A New Industry or Another Debacle?*, Sec. Reg. & L. Rep. (BNA) 1–20 (Special Supp. Apr. 7, 1976) (describing return of fly-by-night commodity options firms).

200. 17 C.F.R. § 32.11 (1978). Several of these firms grew quickly and were selling options on a national basis to unsophisticated customers; fraud was widespread. The CFTC also discovered that one of the larger of these firms was owned and operated by a felon who had escaped from prison. Kelley v. Carr, 567 F. Supp. 831 (W.D. Mich. 1983). At the time it suspended options trading, the CFTC was devoting a large amount of its resources to options problems. *See Extend Commodity Exchange Act: Hearings on H.R. 10285 Before the House Subcomm. On Conservation and Credit of the House Comm. on Agriculture*, 95th Cong. 39 (1978) (statement of William Bagley, CFTC

but the SEC used the scandals as the basis for an unsuccessful attempt to wrest jurisdiction from the CFTC during the latter's reauthorization hearings in 1978,[201] seeking regulatory authority on all instruments involving securities. The Treasury Department also desired a role where treasury securities were involved. Congress, however, refused to entertain these demands and merely directed the CFTC to consult with the SEC and the banking regulators where instruments they regulated were the subject of commodity futures or options trading.[202]

Another threat to the SEC was the decision by the CFTC to approve futures trading on stock indexes.[203] These contracts were almost immediately popular and spread to other commodity exchanges. The SEC retaliated by approving the trading of options on GNMA certificates on the CBOE. The commodity exchanges challenged this action in court and won before the Seventh Circuit.[204] By this point, the SEC realized that it was fighting a losing battle in trying to encroach on the CFTC's ju-

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Chairman, describing resources expended by CFTC on options problems). The CFTC allowed some options trading to continue, including options entered into by commercial firms. Exemptions, 17 C.F.R. § 32.4 (2002). The CFTC also later allowed commodity options trading to be conducted on commodity exchanges, which provided a regulatory structure for excluding the fly-by-night firms that led to the retail over-the-counter options suspension. Regulation of Domestic Exchange-Traded Commodity Options, 46 Fed. Reg. 54,500 (1981).

201. *See* MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 99–100 (describing jurisdictional fight). The SEC had regulatory problems of its own with respect to exchange traded stock options. As the result of abuses, the SEC suspended further expansion of such trading and conducted an extended study of the stock options market. After some reforms, the SEC allowed trading to continue. *See generally* REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS TO THE SEC. AND EXCH. COMM'N, 96TH CONG. (Comm. Print 1978) (describing abuses).

202. MARKHAM, HISTORY OF COMMODITY FUTURES TRADING, *supra* note 98, at 99–100

203. The Kansas City Board of Trade inaugurated the trading of index futures in 1982. Chicago Board of Options Exch., Inc. v. Board of Trade, 459 U.S. 1026 (1982); Board of Trade v. SEC, 677 F.2d 1137, 1171 n.11 (7th Cir.), *vacated as moot sub. nom*. *See also* Standard & Poor's Corp. v. Commodity Exch. Inc., 683 F.2d 704 (2d Cir. 1982) (describing stock index futures); Jerry W. Markham & David J. Gilberg, *Washington Watch — Stock Index Futures*, 6 CORP. L. REV. 59 (1982) (same).

204. Chicago Board Options Exchange, Inc. v. Board of Trade, 459 U.S. 1026 (1982); Board of Trade v. SEC, 677 F.2d 1137 (7th Cir.), *vacated as moot sub. nom.*

risdiction; it had learned that it could not win a confrontation in Congress over this matter. The futures industry lobby was simply too strong, and the agricultural committees were captive of those interests. The natural result was to establish an administrative démarche: an agreement was hammered out between the Chairmen of the SEC and CFTC (the "Shad-Johnson Accords"), which allocated jurisdiction between their two agencies.[205] Thereafter, Congress enacted the Shad-Johnson Accords into law.[206] In brief, the CFTC was given exclusive jurisdiction over all commodity futures trading on any instrument, except that single stock futures were prohibited, joining onions as the only commodity on which futures trading was banned.[207] The SEC was given what amounted to a veto over commodity futures contracts on indexes,[208] and retained jurisdiction over options trading on the stock exchanges, including options on indexes.[209] The SEC and CFTC shared jurisdiction over options trading on foreign currency.[210]

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205. CFTC and SEC Jurisdictional Agreement: Proposed Legislation, Comm. Fut. L. Rep. (CCH) ¶ 21,332 (Feb. 2, 1982).

206. Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (codified in scattered sections of 7 U.S.C.).

207. 7 U.S.C. § 2 (2000).

208. *See generally* Don L. Horwitz & Jerry W. Markham, *Sunset on the Commodity Futures Trading Commission: Scene II*, 39 BUS. LAW. 67, 73–74 (1983) (describing scope of Shad-Johnson Accords and veto authority of SEC on indexes). This veto authority led to another dispute with the CFTC that was temporarily resolved by another inter-agency agreement. Edward J. Kane, *Regulatory Structure in Futures Markets: Jurisdictional Competition Between the SEC, the CFTC, and Other Agencies*, 4 J. FUT. MARKETS 367, 375 (1984). Several years later, the SEC approved options trading on two Dow Jones indexes and then used its veto power to deny trading of commodity futures on those same indexes. The Seventh Circuit set that incredible bit of regulatory chutzpah aside. Board of Trade v. SEC, 187 F.3d 713 (7th Cir. 1999).

209. The CFTC could not approve options on stock indexes, but it was allowed by the Shad-Johnson Accords to approve options on futures on indexes. Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (codified in scattered sections of 7 U.S.C.).

210. The SEC had jurisdiction where options on currency were traded on the stock exchanges. The CFTC had jurisdiction over options trading on commodity exchanges and the over-the-counter market. Trading in the over-the counter market in currency options would plague the CFTC over the next several years. *See* 13A MARKHAM, FRAUD, MANIPULATION & OTHER CLAIMS, *supra* note 124, § 27:13 (describing cases brought by CFTC against over-the-counter currency dealers).

This cooperative allocation of jurisdiction did not mask the fact that there were two very distinct regulatory cultures at the CFTC and SEC. The CEA, the predecessor to the CFTC, was largely driven by economists; the agency had only one lawyer on staff. The CFTC inherited the CEA's personnel, and most of the former SEC staff members, who were recruited when the CFTC was first formed, quickly departed. The economists at the CFTC, however, were willing to defer to the exchanges and had an antipathy towards a heavily rule-based regulatory structure. The occasional activist-lawyer chairman at the CFTC was unable to change that culture. As a result, the futures industry was allowed to develop essentially on its own.[211] In contrast, the SEC maintained an activist culture driven by lawyers who believed fervently in regulation. The SEC was quite willing to direct the development of the market, having lost confidence in the industry to do so as a result of the paperwork crisis.[212] The central market concept was apace with that view.[213] The SEC was intrusive in its regulation of the exchanges and broker-dealers, and was forever seeking to expand its jurisdiction.[214]

When given the opportunity, traders often voted with their feet in assessing the relative efficiency of the commodity futures and stock exchanges. Stock index futures fit neatly into the

211. The CFTC staff did believe strongly that the Commodity Exchange Act created a monopoly that required futures, and later options, to be traded on a contract market licensed by the CFTC. *See generally* Markham, *The Commodity Exchange Monopoly, supra* note 128 (describing CFTC support for the exchange trading requirement).

212. *See supra* notes 159, 176–79 and accompanying text.

213. *See supra* note 44 and accompanying text.

214. In fairness to the SEC, it was deregulating some important aspects of the market, i.e., institutional investors, by exempting sales to "accredited investors" from the registration requirements of the Securities Act of 1933. *Compare* Jerry W. Markham, *Protecting the Institutional Investor — Jungle Predator or Shorn Lamb?,* 12 YALE J. ON REG. 345 (1995) (describing regulatory structure for institutional investors and urging even less regulation), *with*, Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 B.Y.U. L. REV. 1493 (seeking greater regulation to protect institutional investors). Integrated disclosure and shelf registration were also useful in allowing capital raising to be carried out more efficiently. *See generally* Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747 (1985) (describing SEC disclosure system).

modern portfolio theory of a diversified portfolio.[215] Program trading, dynamic hedging, and index arbitrage offered additional opportunities for the adroit trader.[216] Futures trading on indexes and interest rate instruments soon outstripped volume on the more traditional agriculture futures contracts.[217] Futures contracts were efficient and presented low costs to traders, who did not need to buy and sell the stock underlying the index in order to profit from, or hedge against, fluctuations. This avoided the transaction costs associated with buying and selling the underlying securities.[218] Low margins and liquidity also made stock futures extremely popular with institutional investors, while interest rate futures were of equal or greater interest to portfolio managers with investments in fixed income securities. The stock markets and futures markets soon became intermingled and interdependent with this trading. The danger

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215. *See generally* ROBERT L. HAGIN, THE DOW-JONES IRWIN GUIDE TO MODERN PORTFOLIO THEORY (1979); JONATHAN R. MACEY, AN INTRODUCTION TO MODERN FINANCIAL THEORY (2d ed. 1998) .

216. *See generally* 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) (describing these concepts).

217. Between 1983 and 1994, the volume in financial futures increased from 40% of all futures contracts traded to 83%. By 1994, financial futures accounted for 97% of the trading volume on the Chicago Mercantile Exchange. Steven C. Livingston, *Rift Grows Between Factions at CBOT*, WALL ST. J., Sept. 26, 1994, at C1.

218. For example, assume that the manager of a portfolio that tracks the S&P 500 stock index believes that the market will be falling over the next three months. The manager could sell out the portfolio and buy it back in when he anticipates recovery. Alternatively, the manager could passively invest and do nothing, a popular strategy but one that assumes a market recovery before the portfolio funds are needed. Alternatively, the manager could hedge by selling the S&P 500 futures contract. The only cost is commissions, which can be negotiated to a minimal level. This locks in the value of the portfolio in the event of a market decline. Of course, the portfolio value is also locked in if the portfolio manager was wrong. For those interested, and many were, stock baskets matching the S&P 500 and other indexes could be purchased through the stock markets. This, of course, required payment for the full value of the stocks in the basket or 50% margin, as compared to the 5% or less that had to be placed only as security for index futures trading. *See generally* SEC DIVISION OF MARKET REGULATION, THE ROLE OF INDEX-RELATED TRADING IN THE MARKET DECLINE ON SEPTEMBER 11 AND 12, 1986 (1987) (describing use of stock index baskets to facilitate arbitrage trading).

of this interdependence was brought dramatically home in the stock market crash of 1987.[219]

The stock and commodity markets experienced a near meltdown during the stock market crash that occurred in October 1987. The decline was the largest ever experienced to that date, exceeding even the 1929 crash.[220] Numerous regulatory reports resulted from that event.[221] A Presidential commission headed by later Secretary of the Treasury Nicholas Brady (the "Brady Commission") concluded that the securities and commodity futures markets had become intertwined and that a lack of coordinated regulation between the SEC and CFTC was endangering the markets.[222] The Brady Commission recommended a regulatory restructuring whereby a single agency would be authorized to regulate such matters as margin and credit and information systems.[223]

The Brady Commission recommendations and the fallout from the stock market crash of 1987 set off another turf war between the CFTC and the SEC. Even so, the SEC's report on the market crash made some startling admissions, including a concession that the futures markets were popular because they were more efficient than the securities markets and were even

219. Even before the crash, the NYSE was warning of a danger of a "meltdown" in the stock markets caused by futures trading in indexes. Martin Mayer, *Some Watchdog! How the SEC Helped Set the Stage for Black Monday*, BARRON'S, Dec. 27, 1987, at 18.

220. Comparisons were drawn between the stock market crashes in 1929 and 1987, suggesting the possibility of another depression. Randall Smith, *Market Seers Fret over Analogies to '29-'30, Despite Economic Vigor*, WALL ST. J., Mar. 31, 1988, at 25. Fortunately, that did not occur. The market also faced even larger drops in subsequent years. *See, e.g., Gloomy Return: U.S. Stocks Plummet As Trading Resumes Without Major Hitch*, WALL ST. J., Sept. 18, 2001, at A1 (describing record drop after trading resumed following September 11, 2001 terrorist attacks on the World Trade Center and the Pentagon).

221. *See* Markham & Stephanz, *supra* note 216, at 2006–21 (describing these reports).

222. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS, *reprinted in* Fed. Sec. L. Rep. (CCH) Special Report No. 1267 (Jan. 12, 1988) (report by the Brady Commission).

223. The Brady Commission recommended the Federal Reserve Board as the agency to serve as a super regulator. *Id*. at 42.

leading the stock exchanges in setting prices.[224] The SEC was concerned, however, that market volatility had increased significantly as a result of futures trading on securities due to low margins in the futures industry.[225] This reflected another cultural regulatory difference between the SEC and CFTC. Volatility is an accepted, indeed required, part of the futures markets. Futures are not needed for commodities with stable prices. Such commodities do not need the benefits of hedging, and speculators are uninterested because there is no profit to be made from a stable price.

In contrast, the SEC has a constituency of small investors that are content with stable prices — they invest in dividend stocks in such cases — and love for prices to go higher. These small investors do, however, loathe a drop in prices. When that happens, the small investors' capital is reduced, which they find intolerable. Complaints are made to the SEC and to Congress, demanding protection from such events — a drop in prices or a loss on an investment requires a bogeyman; someone must be punished. The SEC's regulations reflect this bias, as evidenced by its "tick test" for short sales.[226] (There is no such test for long traders.) In contrast, the CFTC has no tick test; rather, the commodity futures exchanges use price limits — now called "circuit breakers" — to halt trading when prices move up *or* down in specified amounts. This gives traders an opportunity to assess market conditions and obtain margin funds.[227] There is no long or short bias in these limits.

The Brady Commission believed that margin requirements should be harmonized across markets, a recommendation that the SEC joined.[228] They were undercut somewhat by an earlier

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224. The tail was indeed wagging the dog. *See* SEC DIVISION OF MARKET REGULATION, THE OCTOBER 1987 MARKET BREAK 3-6 (1988) (finding that commodity futures exchanges were leading the stock exchanges in pricing).

225. *See id*. at 3-7 to 3-8 (describing how the futures markets have increased stock market volatility).

226. Short Sales, 17 C.F.R. § 240.10a-1 (2002). *See generally* David C. Worley, *The Regulation of Short Sales: The Long and Short of It*, 55 BROOK. L. REV. 1255 (1990).

227. *See* Markham & Stephanz, *supra* note 216, at 2034–35 (describing price limits and noting that they were first used by the commodity exchanges before World War I).

228. *See* Markham, *Federal Regulation of Margin*, *supra* note 114, at 118 (describing SEC and Brady Commission advocacy of higher margins).

Federal Reserve Board study, which had concluded that even margin requirements on stocks were no longer serving the purposes originally intended by Congress.[229] The SEC again lost the battle,[230] and the only substantive regulation to emerge from the stock market crash of 1987 was the introduction of circuit breakers that halted trading when large market moves occurred. Even this regulation was mostly abandoned in later years because traders did not like these restraints.[231]

But another game had arrived for the CFTC and SEC to scrimmage over. Financial engineering had become an accepted science with the development of numerous new instruments having characteristics of both futures and options.[232] The swap contract was one such product; its popularity was almost instantaneous and it soon became a substantive part of corporate

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229. A REVIEW AND EVALUATION OF FEDERAL MARGIN REGULATIONS: A STUDY BY THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Dec. 1984) (on file with author). The Fed later adopted margin requirements based on good faith loan value for many non-equity securities, which essentially meant that credit could be extended to the purchaser in amount equal to what the lender thought the securities were worth to secure the loan. 63 Fed. Reg. 2806, 2811–13 (Jan. 16, 1998). The Fed at one point did express a desire to have uniform margins for futures and options, but believed the purpose of such margins should be clearing house protection and not to regulate speculation. *See* Markham, *Federal Regulation of Margin*, *supra* note 114, at 110, 112, 122 (describing Fed's views on margin).

230. *See* Markham, *Federal Regulation of Margin*, *supra* note 114, at 119–24 (describing margin fight led by SEC in the Working Group on Financial Markets created by President Reagan to address the concerns raised by the Brady Commission report). In a bit of silliness, Congress did grant the power to set margins on stock indexes to the Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590, 3629 (codified in scattered sections of 15 U.S.C.). The Fed ceded that authority to the CFTC, which in turn relinquished it to the commodity exchanges — precisely where the authority had started. *See* Markham, *The CFTC Net Capital Rule*, *supra* note 167, at 1093 n.12 (describing delegation of this authority).

231. *See* Andrew Hill & John Labate, *Assault on American Finance*, FIN. TIMES (London), Sept. 17, 2001, at 5 (describing history of circuit breakers and their widening).

232. The Seventh Circuit held that the SEC had improperly approved the trading of so-called "index participation" contracts ("IPs") on the CBOE and that these contracts fell within the exclusive jurisdiction of the CFTC. Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989), *cert. denied sub nom.*, Investment Company Institute v. SEC, 496 U.S. 936 (1990).

finance.[233] The CFTC awakened only slowly to this threat, but eventually responded by seeking to curb the growth of over-the-counter commodity-related instruments.[234] It adopted regulations that created an inscrutable formula for determining whether particular instruments would be required to trade only on a commodity exchange.[235] This effort proved to be less than successful, and the CFTC was left to struggle with a growing list of derivative instruments that were being introduced in the market.

In the early 1990s significant losses were encountered by a number of large institutions — Gibson Greeting and Procter & Gamble suffered tremendously; Orange County in California and the Barings Bank went bankrupt, to name just a few.[236] These losses touched off another round of handwringing at the SEC and more studies.[237] Still, nothing was done, except that the SEC brought a case claiming that certain of these instruments were securities,[238] and the CFTC brought another case claiming that other instruments were futures that had to be traded on a contract market.[239] A furor ensued, and both agencies' rulings were undercut by court decisions.[240] The SEC then

233. *See generally* Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance Into the Abyss?,* 43 AM. U. L. REV. 1023 (1994) (describing swaps).

234. *See generally* Jerry W. Markham, *Regulation of Hybrid Instruments Under the Commodity Exchange Act — Alternatives Are Needed*, 1990 COLUM. BUS. L. REV. 1 (1990) (describing the development of over-the-counter derivatives).

235. Under these rules, unless otherwise regulated, if the instrument's commodity futures or options element outweighed its securities characteristics, it had to be traded on a commodity futures exchange. Regulation of Hybrid Instruments, 17 C.F.R. §§ 34.1–34.3 (2002).

236. *See* Jerry W. Markham, *"Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments*, 25 SETON HALL L. REV. 1, 28–31 (1994) (cataloguing losses).

237. *Id.* at 32–40 (describing the reports).

238. In re BT Securities, 52 S.E.C. 109, 113–15 (1994) (consent order).

239. In re BT Securities, CFTC Doc. No. 95-3, at 95-4 (C.F.T.C. 1994) (consent order). *See also* In re M.G. Refining & Marketing, Inc., CFTC Doc. No. 95-14 (C.F.T.C. 1995) (illegal over-the-counter trading in a futures product).

240. Thereafter, the SEC exempted dealers from registration as broker-dealers if they engaged in such activities. To the extent government securities were involved, they were exempt securities. 23A MARKHAM & HAZEN, *supra* note 35, § 14.9. A district court also held that contracts similar to those claimed to be securities by the SEC were not such. Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1274 (S.D. Ohio 1996). *But see* Caiola

proceeded to create a safe harbor from onerous regulation through so-called "Broker-Dealer Lite" registration.[241] The CFTC viewed this as a threat to its jurisdiction and announced a plan to conduct an investigation of over-the-counter derivatives to determine whether they should be regulated, though the industry viewed this as no more than a cover to lay the groundwork for such regulation. The SEC, the Treasury Department, and the Federal Reserve Board all weighed in against such a jurisdictional grab. In the end, Congress responded with legislation that stopped the CFTC.[242] Yet all of this commotion was for naught — as of the beginning of 2000, only one firm had registered as a Broker-Dealer Lite.[243]

V. MARKET STRUCTURE CHANGES

The financial services sectors were undergoing sweeping changes while the SEC and CFTC competed with each other in their regulatory programs. Banks were increasing their penetration of the securities industry through "Section 20" subsidiaries that could engage in limited dealing in securities.[244] The

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v. Citibank, N.A., 295 F.3d 312 (2d Cir. 2002) (disagreeing with analysis of the court in *Procter & Gamble*).

The CFTC had to back off its expansive ruling. *C.F.T.C. Says Ruling Didn't Expand Scope*, N.Y. TIMES, Jan. 23, 1996, at D4. *See also* In re MG Ref. & Mktg. Litig., Comm. Fut. L. Rep. (CCH) ¶ 26,956 (S.D.N.Y. 1997) (CFTC consent decree was not binding as collateral estoppel). *See generally* Alton B. Harris, *The CFTC and Derivative Products; Purposeful Ambiguity and Jurisdictional Reach*, 71 CHI.-KENT L. REV. 117 (1996) (describing the CFTC and SEC cases against BT Securities).

241. 17 C.F.R. § 240.3b-13 (2002). Broker-Dealer Lite is a regulatory structure created by the SEC in 1998. It gives securities firms the option to establish OTC dealer affiliates ("OTC Derivatives Dealers") that operate under lower net capital requirements and less stringent margin rules than are applicable to other broker-dealers. *See generally* OTC Derivatives Dealers, Release No. 34-40,594, 63 Fed. Reg. 59, 362 (Nov. 3, 1998).

242. *See* 23 MARKHAM & HAZEN, *supra* note 35, § 2.09 (describing this regulatory dust-up).

243. *Id.* § 2.10.

244. Banks were allowed to acquire discount brokers. *See* Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Sys., 468 U.S. 207 (1984). The Fed also allowed bank subsidiaries to engage up to 5% of their business in otherwise ineligible securities under the Glass-Steagall Act. *See* Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Sys., 839 F.2d 47 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1989). The limitation was subsequently increased first to 10%, and later to 25%, which was sufficient to allow banks to own large full service

bank regulators continued to drop barriers to bank entry into the commodity futures and options business,[245] and insurance became a popular bank product.[246] Finally, the GLBA freed the banks of most of the remaining Glass-Steagall restrictions on their financial services activities.[247]

In the meantime, the world of derivatives and securities trading had changed. Over-the-counter instruments, such as swaps, caps, collars and floors, were an increasingly popular alternative to exchange-traded commodity futures and options. Competition from abroad was also posing a major threat to the dominance of the American futures and options markets. The commodity exchanges in America had long ruled the futures markets, but the largest futures exchange in the world at the end of the twentieth century was Eurex, a German exchange.[248] How did this come to pass? Foreign exchanges had undercut the American markets mostly through electronic trading. The monopoly given to the contract markets by the Commodity Exchange Act of 1936 had created an industry tied to the trading floors. The floor members controlled the exchanges and were loathe to give up the time and place advantage on the floor to an electronic forum where everyone has equal access.[249] Members' capital was at risk, so they would cling to this franchise as

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broker-dealers. Revenue Limit on Bank-ineligible Activities of Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities, 61 Fed. Reg. 68,750, 68, 751 (Dec. 30, 1996).

245. The leading derivatives dealers in 1993 were mostly banks. Markham, *Banking Regulation: Its History and Future, supra* note 4, at 259.

246. Broome & Markham, *supra* note 19, at 763–64.

247. Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 U.S.C.).

248. Adding to the embarrassment from this loss of position was the fact that Germany had barred futures trading until the end of the 1980s. 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 INT'L BUS. 273 (1987). Volume is still high on American exchanges, but Eurex is the leader. Christopher Bowe, *Survey — World Stock and Derivative Exchanges*, FIN. TIMES (London), June 6, 2002, at 4. Commodity exchanges in the U.S. were conducting only 40% of futures trading worldwide in 1997, down from 78% in 1988. Fred Vogelstein, *Futures Marts in the U.S. Run Scared*, WALL ST. J., June 10, 1996, at C1.

249. *See generally* Bowe, *supra* note 248, at 4 (describing how the Chicago Board of Trade clings to its open outcry trading system and falls from first to third place in exchange trading volume).

long as possible.[250] Market share gradually slipped away to the over-the-counter derivative markets and to the electronic exchanges abroad. Like the American car manufacturers in the 1970s, the exchanges and their members saw their volume being eroded by more nimble competitors, but refused to compete, preferring shelter in their dwindling market share to the risks of competition.

The commodity exchanges in America were unable to push through regulations that would stop the over-the-counter trading. Swaps and other such derivatives had slipped past the lobbyists for the exchanges and were now too big to stop. Furthermore, the CFTC was cut off from regulating over-the-counter derivatives by Congress after the Broker-Dealer Lite fiasco. The exchanges then decided to seek entry to over-the-counter trading.[251] The CFTC adopted rules to deregulate over-the-counter derivatives.[252] This proposal was enacted into law by the Commodity Futures Modernization Act of 2000 ("CFMA").[253] Among other things, the legislation, through what in part is sometimes called the "Enron amendment," exempted most over-the-counter derivatives from regulation as long as the parties were large institutions or wealthy individuals.[254] The commodity exchanges were allowed to keep their contract market monopoly over markets in which small traders were allowed to participate. The CFMA also allowed trading in single stock futures under a strange formula in which the CFTC and SEC

250. *See generally* Markham, *The Commodity Exchange Monopoly, supra* note 128, at 1014–15 (describing franchise concerns of floor members). Demutualization, however, offers a way for the exchange members to recapture their capital investment and seek to become more competitive. *See generally* Caroline Bradley, *Demutualization of Financial Exchanges: Business as Usual?,* 21 NW. J. INT'L L. & BUS. 657 (2001) [hereinafter Bradley, *Demutualization*].

251. *See* John M. Broder, *Wide Open Once Again? Chicago Exchanges Seek to Loosen Yoke of Regulation*, N.Y. TIMES, June 4, 1997, at D1.

252. *See* A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed. Reg. 42,256 (Aug. 10, 2001).

253. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended in scattered sections of 7 U.S.C.).

254. The amendment received this informal reference as a result of the fact that the Enron Corporation, a large trader in over-the-counter energy derivatives, was its principal sponsor before the company went bankrupt.

shared jurisdiction.[255] Commodity markets conducting trading in single stock futures were required to adopt rules equivalent to those in the securities industry, including insider trading prohibitions.[256] Margin requirements also had to match those in the securities industry. The level for stock margins was therefore applied, a level several magnitudes greater than for futures trading.[257] This was one of the few instances where Congress rejected competitive regulation and mandated that the CFTC adopt SEC requirements.

Although the SEC won this regulatory encomium from Congress, it was facing other challenges. The securities markets

255. The Shad-Johnson Accords had prohibited such single stock futures. *See* note 206 and accompanying text. For the CFTC's notice rules for securities exchanges to become designated contract markets in securities products, see Designated Contract Markets in Security Futures Products: Notice-Designation Requirements, Continuing Obligations, Applications for Exemptive Orders, and Exempt Provisions, 66 Fed. Reg. 44,960 (Aug. 27, 2001).

256. The National Futures Association ("NFA") was required to conform its customer protection rules to those of the SEC, thereby introducing insider trading prohibitions into the futures markets. *See* Self Regulatory Organization; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Futures Association Relating to Security Futures Products, Exchange Act Release No. 34-44,823, 66 Fed. Reg. 49,439 (Sept. 27, 2001) (NFA conforming its rules). Customers trading on the futures markets will not receive SIPC insurance, but customers trading such instruments on securities markets will be insured. Applicability of CFTC and SEC Customer Protection, Record Keeping, Reporting and Bankruptcy Rules, Comm. Fut. L. Rep. (CCH) ¶ 28,641 (C.F.T.C. & S.E.C. 2001).

257. The Commodity Futures Modernization Act of 2000 ("CFMA") amended Section 7(c) of the Securities Exchange Act of 1934 to provide the Federal Reserve Board with authority to set margin requirements for futures on individual securities and narrow based indexes. The Federal Reserve Board delegated this rule- making authority jointly to the CFTC and the SEC. Customer Margin Rules Relating to Securities Futures, Exchange Act Release No. 34-44,853, 66 Fed. Reg. 50,720 (Sept. 26, 2001). The CFMA required margin for single stock futures to be no lower than the lowest level of margin required for comparable options contract traded on national securities exchanges. Rules proposed by the CFTC and SEC established a minimal initial and maintenance margin level of 20% of the current market value of the position. This 20% level is far in excess of the normal margin requirements for futures contracts in the commodity futures industry, where margins are often less than 5% of the value of the contract. Customer Margin Rules Relating to Securities Futures; Applicability of CFTC and SEC Customer Protection, Recordkeeping, Reporting, and Bankruptcy Rules, Exchange Act Release No. 34-44,996, 76 S.E.C. Docket 383 (Oct. 29, 2001); Customer Margin Rules Relating to Securities Futures, Exchange Act Release No. 34-44,853, 66 Fed. Reg. 50,720 (Sept. 26, 2001).

were trending up during most of the 1990s, volume was increasing, and more investors were being drawn into the markets. Despite all of these positive aspects, the securities markets, like the futures markets, faced many challenges due to new computer technology. The computer allowed the creation of "SOES Bandits,"[258] and these traders soon became "day traders." The computer thus allowed even small traders to trade like professionals, creating a new set of regulatory problems for the SEC.[259] In addition, the Internet permitted small investors to

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258. SOES Bandits is a reference to traders who used the automated Nasdaq Small Order Execution System ("SOES") to pick off market maker quotes before they could be changed where an event with market effect occurs. The Nasdaq market makers were subject to stiff withdrawal restrictions after they exited the market en masse during the stock market crash of 1987. *See* Timpinaro v. SEC, 2 F.3d 453 (D.C. Cir. 1993) (describing SOES Bandits). To avoid the SOES Bandits, the Nasdaq market makers engaged in several collusive practices that became the subject of an SEC investigation and caused the reorganization of the NASD. *See* In re Certain Market Making Activities on NASDAQ, Exchange Act Release No. 34-40,900, 68 S.E.C. 2693 (Jan. 11, 1998) (order describing these collusive practices).

259. *See generally* Caroline Bradley, *Disorderly Conduct: Day Traders and the Ideology of "Fair and Orderly Markets,"* 26 J. CORP. L. 63 (2000) (describing problems caused by, and regulation of, day traders). The day trader entered orders through computerized systems operated by discount brokers at low commission rates. The system allowed day traders to "scalp" by quick in-and-out trades that sought short term profits. However, most day traders in fact lost money. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 333–34 (survey finds that 90% of day traders lost money). These traders raised the concern that their trading was adding volatility to the market. *See* Edward Watt & David Barboza, *Internet Stocks Falter, Causing Wider Worries*, N.Y. TIMES, Jan. 23, 1999, at A1. Day traders were often avoiding or evading margin requirements by having their broker-dealer arrange loans among customers and by closing out positions before the end of the trading day. *See generally* Ruth Simon, *Day-Trading Firms' Moves that Skirt Margin-Lending Rules are Being Probed*, WALL ST. J., June 23, 1999, at C1. The NYSE and NASD imposed special margin restrictions on day traders to curb these practices. Order Approving Proposed Rule Changes Relating to Margin Requirements for Day Trading, Exchange Act Release No. 34-44,009, 74 S.E.C. Docket 1000 (Feb. 27, 2001). For more on day trading margin requirements, see *id.* Short sale tick test restrictions were also being avoided by these traders. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 333. The SEC, the CFTC, and the FTC (still another layer of regulation) conducted a coordinated sweep operation that resulted in fourteen firms being charged with fraud in promoting their day trading programs. Ronald Taylor, *14 Firms Snagged in Coordinated Move as Day Trading Promoters Cited for Fraud*, Sec. Reg. & L. Rep. (BNA) 586 (May 8, 2000). There were also some tragedies. Mark (the "Rocket"), a failed day trader, attacked his brokerage

trade online.[260] This medium was also used to evade the gatekeeper status of analysts, so that "pump and dump" schemes became common.[261]

More threatening to the status quo in the securities industry were the electronic communication networks ("ECNs"), which were no more than order matching services that had no market makers.[262] ECNs were popular with institutions because they removed intermediaries, such as the exchange specialist, from the transaction, thereby saving costs.[263] The SEC ruled initially that ECNs were not exchanges because they did not make a continuous market in securities,[264] thus freeing the ECNs from the onerous regulation imposed by the SEC on the exchanges. The popularity of ECNs distressed Nasdaq and the stock exchanges, since they were losing large amounts of volume to

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firm and killed twelve people. Another failed day trader threw his wife off a balcony in order to obtain the proceeds from her life insurance policy. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 334.

260. Online trading was a boon for the discount brokers and posed a threat to the large full service brokers. Charles Schwab, the largest online broker, saw its stock capitalization value exceed that of Merrill Lynch (but dropping to less than half of that of Merrill Lynch after the market downturn that began in 2000). Merrill Lynch resisted the introduction of online trading, but was finally forced by competition to offer this product. *See* 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 295–97, 353.

261. HAZEN TREATISE, *supra* note 51, § 14.18, at 292 (describing pump and dump schemes). These operations involved such colorful characters as Tokyo Joe's S.A. and various students, causing the SEC to set up an Office of Internet Enforcement and a "cyberforce" to which 200 lawyers were assigned. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 293, 344–45.

262. Instinet was the pioneer in this field. *See* Rebecca Buckman, *Plan by Chicago Exchanges to Offer Extended Trading is Sign of the Times*, WALL ST. J., Aug. 23, 1999, at C11. Island ECN has also been a popular electronic trading platform. It was seeking to become an exchange. Greg Ip, *Trading Places: The Stock Exchanges, Long Static, Suddenly are Roiled by Change*, WALL ST. J., July 27, 1999, at A1.

263. *See generally* Greg Ip et al., *Market Structure Debate Embroils Street*, WALL ST. J., Feb. 22, 2000, at C19 (describing growth of ECNs).

264. *See, e.g.*, Self-Regulatory Organizations; Delta Government Options Corp.; Order Granting Temporary Registration as a Clearing Agency, Exchange Act Release No. 34-27611, 55 Fed. Reg. 1890 (Jan. 19, 1990) (describing "exchange" as one that maintains a continuous market); Self-Regulatory Organizations; Delta Government Options Corp.; Order Granting Temporary Registration as a Clearing Agency, Exchange Act Release No. 34-27,611, 55 Fed. Reg. 1890 (Jan. 12, 1990) (same). Nasdaq could itself be defined as an ECN except that it makes a continuous market in securities.

those operations.[265] The large brokerage firms heightened the exchanges' fear with a proposal for a centralized electronic trading system with a central limit order book ("CLOB").[266] Defenders of the exchanges claimed that the ECNs were becoming a cover for the large broker-dealers to internalize their order flow upstairs and away from the exchanges. Critics claimed that CLOB would fragment the market, making it less transparent and, therefore, less efficient.[267] The SEC was sympathetic to the exchanges and raised its long-dead central market concept to suggest an alternative centralization of electronic trading that would prevent fragmentation and preclude the internalization of order flows by broker-dealers.[268] It might seem odd to think of the government defending cartels like the stock exchanges from competition.[269] In the end, the SEC retreated from its proposal, but eventually adopted a regulation designed to make the ECNs more transparent.[270]

Like the commodity exchanges, the stock markets were an endangered species.[271] Despite the regulatory competition be-

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265. Nasdaq is retaining only 28% of the volume in the stocks it trades. ECNs were accounting for 42.5% of the volume in Nasdaq stocks in the second quarter of 2002. Jeremy Adams, *Nasdaq Losing Ground to ECNs*, EFINANCIALNEWS, Aug. 5, 2002, *available at* LEXIS, Financial News Group. For a description of the proliferation of ECNs, see 23A MARKHAM & HAZEN, *supra* note 35, § 13.02.

266. Michael Schroeder & Randall Smith, *Sweeping Change in Market Structure Sought*, WALL ST. J., Feb. 29, 2000, at C1.

267. Holman W. Jenkins, Jr., *Wall Street Fuddy Duddies CLOBber the Future*, WALL ST. J., Mar. 8, 2000, at A23. *See also* Matthew Andersen, *Don't CLOBber ECN's*, WALL ST. J., Mar. 27, 2000, at A48 (discussing effect of a CLOB requirement on ECNs).

268. Gretchen Morgenson, *SEC Chief Wants One Site for Posting All Stock Prices*, N.Y. TIMES, Sept. 24, 1999, at A1.

269. *See* Randall Smith, *Will NYSE Get Bowled Over by Rivals?,* WALL ST. J., Jan. 19, 2000, at C1.

270. Regulation ATS (Alternate Trading Systems), 17 C.F.R. § 242.300 (2002).

271. Although the ECNs have not aggressively targeted the NYSE, that exchange had lost a large amount of market share to Nasdaq. The Chicago Stock Exchange was attacking both the NYSE and Nasdaq by trading through the Internet. It became the second largest stock exchange in the U.S., ousting Amex, which is owned by Nasdaq, from that position. Joel Seligman, *Rethinking Securities Markets: The SEC Advisory Committee on Market Information and the Future of the National Market System*, 57 BUS. LAW. 637, 672 n.148 (2002). The ECNs have focused on Nasdaq stocks. John Labate, *High — Tech Systems Jolt Old Markets into Action*, FIN. TIMES (London), June 6, 2002, at 4.

tween the CFTC and SEC, both markets had been undercut by their clinging to the franchises given to them under, respectively, the Commodity Exchange Act of 1936 and the Securities Exchange Act of 1934. Both commodity and stock exchanges were undermined by trading in non-conventional (and less regulated) markets. The over-the-counter derivatives threatened the commodity exchanges, and the ECNs were wreaking similar havoc in the stock markets.

VI. FINANCIAL SERVICES AUTHORITY OF THE U.K.

The regulatory structure for financial services in the U.K. has its own history. The Bank of England, which was founded in 1694 as a private institution, provided much of that regulation until the latter part of the twentieth century.[272] Its regulatory role was, however, executed principally through "raised eye-

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Nasdaq responded to this threat by creating its own electronic trading platform — SuperMontage. Kate Kelly, *SEC Clears New Nasdaq Trading Platform*, WALL ST. J., Aug. 29, 2002, at C1. Nasdaq also sought to mimic the European exchanges by demutualizing and selling its own stock to raise capital. Susan Harrigan, *Nasdaq Trading in Old System*, NEWSDAY, July 10, 2002, at A41. *See also* Bradley, *supra* note 250 (discussing demutualization plans of stock and commodity exchanges around the world and implications of that phenomenon). Nasdaq was also seeking linkages with foreign exchanges. Terzah Ewing, *NASD Presents Details of its Plan for Nasdaq Europe*, WALL ST. J., Nov. 5, 1999, at C12. It did not have much success with that effort. David Ibson & Mariko Sanchanta, *Nasdaq Japan Faces Up to Uncertain Future*, FIN. TIMES (London), Aug. 15, 2002, at 29 (describing how the Nasdaq plan to globally link America, Japan, and Germany ran into difficulty in Japan, and Nasdaq decided to withdraw from that market). *See also generally* Phred Dvorak & Craig Karmin, *Saga of Series of Poor Moves*, WALL ST. J., Aug. 19, 2002, at C1 (describing reasons for failure); Isabelle Clary, *Nasdaq Turns to Germany in Bid to Expand Globally*, SEC. INDUSTRY NEWS, June 24, 2002, *available at* 2002 WL 8195226 (Nasdaq seeks new alliances in Europe to expand its trading).

The commodity exchanges were having similar problems. A linkage between Eurex and the Chicago Board of Trade ("CBOT") fell apart in 2002, but the CBOT announced it would be trading electronically side-by-side with its trading floor. David Greising, *On Bickering Street, Sounds of Conciliation*, CHICAGO TRIBUNE, Aug. 2, 2002, at B1. The CBOT was also seeking to demutualize. Jeremy Grant, *CBOT Near Demutualization*, FIN. TIMES (London), Aug. 12, 2002, at 15.

272. The Bank of England was nationalized in 1946, but given operational independence in 1997. Bank of England, *About the Bank: Did You Know . . . Historical Trivia*, *at* http://www.bankofengland.co.uk/didyouknow.htm (last visited Jan. 29, 2003).

brows," a form of regulation lent force by the knowledge that disapproval by the Bank of England could exclude a firm from the financial markets.[273] The Bank was also the U.K.'s central bank and lender of last resort.[274] A more formal bank regulatory system was introduced in the Banking Act 1979,[275] which was in turn replaced by a strengthened Banking Act 1987.[276]

Lloyd's of London, a financial club that self-regulated the City's insurance industry, was shaken by scandals in the 1970s. An investigation was conducted by Sir Henry Fisher at the behest of the government and a new reform law was enacted in 1982.[277] This legislation, however, carried forward Lloyd's self-regulation, and did not prevent further scandals or the losses that came from a series of disasters in the 1980s.[278] The securities and commodity markets in the U.K. also operated in a club-like fashion for much of their history.[279] Though the London Stock Exchange was the primary regulator of morals, the Bank of England and government agencies played a loose role during times of crisis. A Prevention of Fraud Act was adopted in 1958,

273. *See* Jane Martinson, *Nine Finance Watchdogs Must Squeeze Into One Skin*, FIN. TIMES (London), Oct. 9, 1997, at 9 (referencing "raised eyebrow" approach to regulation by the Bank of England).

274. George Peabody & Co. was saved by a loan of £800,000 during the Panic of 1857. His firm would evolve into J.P. Morgan & Co., now JP Morgan Chase. 1 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492–1900), at 357 (2002) [hereinafter 1 MARKHAM, A FINANCIAL HISTORY OF THE U.S.]. The Bank of England would also rescue the Barings banking firm in 1890 during the Baring Panic of that year. *Id.* at 308. The Bank of England declined a further rescue of the Barings bank in 1995, after the firm lost over $1 billion from the unauthorized futures trading of a twenty-eight year old employee, Nicholas Leeson. JUDITH H. RAWNSLEY, TOTAL RISK: NICK LEESON AND THE FALL OF BARINGS BANK (1995).

275. *See* Heidi Mandanis Schooner & Michael Taylor, *Convergence and Competition: The Case of Bank Regulation in Britain and the United States*, 20 MICH. J. INT'L L. 595, 629–35 (1999) (describing bank regulation in the U.K. and the background of the Banking Act 1979 and its revision by the Banking Act 1987).

276. Philip N. Hablutzel, *A Legal Sampler: British Banks' Role in U.K. Capital Markets Since the Big Bang*, 68 CHI.-KENT L. REV. 365, 373 (1992).

277. Lloyd's Act, 1982, c. 14 (Eng.).

278. Ian Kelley, Note, *Regulatory Crisis at Lloyd's of London: Reform from Within*, 18 FORDHAM INT'L L.J. 1924, 1924–25 (1995).

279. For an extensive description of the London financial markets, see 1–4 DAVID KYNASTON, THE CITY OF LONDON (1994).

but it did little to impose affirmative regulation.[280] This regulatory approach was questioned after a series of scandals that began in the 1970s in the securities markets.[281] A collapse of the tin market in 1985 raised additional concerns with regulation. The fiasco cost members of the London Metals Exchange £600 million, as well as threatened the exchange's existence.[282]

In the midst of these events, Professor Jim Gower prepared a white paper for the Department of Trade and Industry[283] on steps needed for investor protection.[284] This led to corrective legislation in the form of the Financial Services Act, which implemented what became known as the "Big Bang" in 1986. The legislation drew heavily from the SEC regulatory model in the U.S., and, among other things, eliminated fixed commissions.[285] Furthermore, the separation of "stock jobbers," (i.e., dealers and brokers), was removed in favor of competing market makers.[286]

The Big Bang legislation also created a Securities and Investment Board ("SIB") that reported to the Department of Trade and Industry. This was a variation on the SEC model — the members of SIB included government officials as well as private individuals, and the SIB had no enforcement powers.[287] Financial firms were required to register with an SRO or with the SIB. The SROs were in turn required to regulate the con-

280. Richard Northedge, *Scandals Led to New Legislation for London Financial District*, SUNDAY BUS. (London), Nov. 20, 2001.

281. Henry Laurence, *The Rule of Law in the Era of Globalization*, 6 IND. J. GLOBAL LEGAL STUD. 647, 660–61 (1999).

282. Kenneth Gooding, *Metals Business Booms*, FIN. TIMES (London), May 5, 1994, at 14.

283. This ministry was the successor to the Board of Trade that regulated the colonies and corporations that owned America before their charters were revoked by the Crown. 1 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 274, at 29–35 (2001).

284. LAURENCE CECIL BARTLETT GOWER, REVIEW OF INVESTOR PROTECTION (1985).

285. Fixed commissions had been eliminated in the U.S. on "May Day" in 1975 as the result of an SEC mandate. H.R. REP. NO. 94-123, at 46 (1975).

286. *See* Patrick M. Creaven, Note, *Inside Outside Leave Me Alone: Domestic and EC-Motivated Reform in the UK Securities Industry*, 60 FORDHAM L. REV. S285, S287–89 (1992) (describing Big Bang legislation). *See generally* Norman S. Poser, *Big Bang and the Financial Services Act Seen Through American Eyes*, 14 BROOK. J. INT'L L. 317, 318 (1988) (describing Big Bang); NORMAN S. POSER, INTERNATIONAL SECURITIES REGULATION: LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES MARKETS 27–31 (1991).

287. Laurence, *supra* note 281, at 662.

duct of their members and could impose fines, censures, and bans.[288] One of the more important of the SROs was the Securities and Futures Authority,[289] which combined the regulation of futures and securities, an approach not followed in the U.S. Although this concept appears to be a mixture of the Municipal Securities Rule Making Board ("MSRB") and the SEC in the U.S.,[290] the SIB was actually a compromise designed to preserve the culture of the City of London's club-like regulation.

The SIB proved to be a reluctant and ineffective regulator, and another series of scandals led to calls for further reform.[291] The scandals included the "Blue Arrow" rights affair, Robert Maxwell's defalcations, the BCCI debacle, and several insider trading cases.[292] The crisis at Barings plc.,[293] then precipitated

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288. Member firms were required to second employees in order to provide a staff for the SROs. *Id.* at 662.

289. Helen Nugent, *Taking Grief Out of Grievances*, INDEP. (London) Sept. 20, 1998, at 20.

290. The MSRB is a self-regulatory body composed of members representing securities firms, bank representatives, and the public. It is a hybrid body that was given the responsibility of enacting rules for the registration and regulation of bank and non-bank municipal securities dealers. Its authority is limited to proposing and adopting rules to regulate transactions in municipal securities. Those rules must be approved by the SEC before they are effective. Enforcement of MSRB rules is left to the SEC, the NASD, and the bank regulatory agencies. HAZEN TREATISE, *supra* note 51, § 10.5, at 539–45.

291. Richard Northedge, *Scandals Led to New Legislation for London Financial District*, SUNDAY BUS. (London), Nov. 20, 2001, *available at* LEXIS, News Group File.

292. *See generally* TOM BOWER, MAXWELL THE OUTSIDER (1992); PETER TRUELL & LARRY GURWIN, FALSE PROFITS: THE INSIDE STORY OF BCCI, THE WORLD'S MOST CORRUPT FINANCIAL EMPIRE (1992); Betty M. Ho, *Rethinking the System of Sanctions in the Corporate and Securities Law of Hong Kong*, 42 MCGILL L.J. 603, 629 (1997) (describing the "Blue Arrow" affair); Barry A.K. Rider, *The Control of Insider Trading — Smoke And Mirrors*, 19 DICK. J. INT'L L. 1 (2000) (discussing lack of enforcement against insider trading).

Pensioners had also been the subject of sales schemes in which, under a new law designed to encourage the privatizing of pensions, they were "mis-sold" on the drawbacks of investing on their own rather than in a public or company pension scheme. Simon Robinson, *Follow the Money*, TIME (Int'l ed.), July 27, 1998, at 36. *See generally* Richard Nobles & Julia Black, *The Privatization Process: Pensions Mis-Selling — The Lessons for Regulating Privatized Social Security*, 64 BROOK. L. REV. 933 (1998); Steve Stecklow & Sara Calian, *Financial Flop: Social Security Switch in U.K. is Disastrous; A Caution to the U.S.?*, WALL ST. J., Aug. 10, 1998, at A1.

293. *See supra* note 274.

more legislation, which created the FSA-UK in 1997.[294] The FSA-UK is an "independent non-governmental body which exercises statutory powers . . . ."[295] The agency was to assume the duties of nine regulatory entities,[296] abandoning the clubby use of SROs.[297] In 1998 the FSA-UK was even given the authority to oversee the banks, taking that power away from the Bank of England.[298]

The FSA-UK became a monolithic super regulator that was firmly in the hands of the government, and was to be "the single governing entity of the entire financial services spectrum, from securities and futures trading to funeral planning."[299] The agency was given responsibility to regulate virtually every aspect of finance, assuming the same roles played in the U.S. by the SEC, the CFTC, federal bank regulators, and state banking, insurance and securities commissions, as well as the SROs.[300] It was also provided with expanded enforcement powers that included the right to bring actions against violators and impose sanctions.[301] The FSA-UK, however, started with only 2,000 employees for the regulation of 10,000 companies.[302] Even so,

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294. Thomas Sims, *Single Regulators Are Catching on in Europe*, WALL ST. J. (International), Mar. 6, 2001, at A14.

295. FSA, INTRODUCTION TO THE FINANCIAL SERVICES AUTHORITY 4 (2001) [hereinafter INTRO. TO THE FSA]. The agency is funded by the industry and is accountable to Treasury Ministers. *Id.*

296. See FSA, *Further Integration of Financial Regulatory Services at the FSA*, (Feb. 2, 2001), *at* http://www.fsa.gov.uk/pubs/press/2001/017.html (listing the integrated regulators); *Nine into One Does Go*, REINSURANCE MAG., June 8, 1998, at 28, *available at* http://www.insurancewindow.net/story.asp?l sectioncode=00&arch=true&storycode=14043 (same).

297. There were to be no industry representatives on the FSA-UK. *Helen Liddell Interview: New Tricks for Old Watchdogs*, INVESTORS CHRONICLE, Oct. 31, 1997, at 21.

298. André Scheerer, *Credit Derivatives: An Overview of Regulatory Initiatives in the U.S. and Europe*, 5 FORDHAM J. CORP. & FIN. L. 149, 198 (2000). The Bank of England retained the right to set interest rates under the Bank of England Act 1998. *See* Bank of England Act, 1998, c. 11, § 7, sched. 2; Bank of England, *About the Bank: Core Purposes*, *at* http://www.bankofengland.co.uk/corepurposes.htm (last visited Feb. 2, 2003).

299. *The Risk Business*, LAWYER, Sept. 10, 2001, at 21.

300. Silvia Ascarelli, *Britain's Fiscal Watchdog to Bite as Well as Bark*, WALL ST. J., Nov. 30, 2001, at A13.

301. *The Seamless Web of Financial Regulation*, COMPLIANCE MONITOR, Oct. 2001, at 1.

302. Ascarelli, *supra* note 300. The agency also admitted that many of these employees were inexperienced in regulation. Suzy Jagger, *Death of Capital-*

immediate concern was raised that the new agency would become bureaucratic and intrusive and seek to implement a rule-based regulatory system like the one in the U.S.[303]

The FSA-UK took several steps to unify regulation. First, a single ombudsman was to be created by the agency to handle complaints by customers in all sectors of public finance,[304] as opposed to the various hotlines for federal and state agencies in the U.S., the numerous arbitration tribunals of the SROs, and the singular reparations procedure at the CFTC in the U.S. The FSA-UK further replaced the six separate insurance funds with a single Financial Services Compensation Scheme ("FSCS"), which provided customers with compensation in the event of the insolvency of a financial service firm.[305] This sharply contrasts with the U.S. system that spreads responsibility among the FDIC, the Bank Insurance Fund, the Savings Association Insurance Fund, the SIPA Corporation ("SIPC"), the Pension Benefit Guaranty Corporation, and the funds created by states for insurance companies.

The FSA-UK is also seeking publication of comparative information disclosures for a range of financial instruments that would allow more informed investment decisions.[306] The FSA-UK assigned one office to develop policy on prudential issues across all financial sectors, so as to develop a common approach

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ism, THE MIRROR (London), June 29, 2002, at 14. *See also* Jeffrey L. Hiday, *Hot Properties: U.K. Regulators Vie for Compliance Staffers in Tight Market*, WALL ST. J., Nov. 3, 1997, at A17 (expressing concern with whether the agency would be able to keep even these employees). The 1999 budget for the FSA-UK was £154 million. George Graham, *Banking Watchdog Budgets for Reduced Costs*, FIN. TIMES (London), Feb. 17, 1998, at 11. In the U.S., the SEC's budget alone was twice that amount and has recently been increased to $ 776 million. Alec Klein & Dan Eggen, *U.S. Opens Criminal AOL Probe: Justice Dept. to Focus on Unusual Accounting*, WASH. POST, Aug. 1, 2002, at AO1.

303. Silvia Ascarelli, *Deals & Deal Makers: New U.K. Financial Regulator Draws Fire*, WALL ST. J., May 30, 2001, at C16.

304. Nugent, *supra* note 289. The FSA-UK appoints the board of this Financial Ombudsman Service ("FOS") and promulgates its rules, but the FOS is operationally independent of the FSA-UK. *See* INTRO. TO THE FSA, *supra* note 295, at 18.

305. *Id.* The FSA-UK appoints the board of the FSCS and promulgates its rules, but the FSCS is operationally independent of the FSA-UK. *See id.*

306. Howard Davies, *The Coming of the Single Financial Regulator*, FIN. TIMES (London), July 16, 2001, at 2.

to risk and capital requirements.[307] There has been no comparable effort in the U.S., where there are separate capital requirements for insurance companies, banks, broker-dealers, and futures commission merchants. As a lawyer for the FSA-UK notes: "[o]ur advantage is that we can look at the market as a whole . . . . We can see what's falling between the cracks."[308] The agency also announced that it was streamlining the existing fourteen rulebooks for financial services into one.[309] The FSA-UK has been focusing its regulatory attention on high-risk firms, while requiring other firms to report and to comply with conduct standards set out in its rulebook.[310] By contrast, the FSA-UK specified several governing principles involving management responsibility and internal control systems, as well as financial requirements.[311] The agency, like the SEC, placed heavy emphasis on supervisory responsibilities of managers.[312] Of course, the FSA-UK did not stop financial problems in the U.K., and, in fact, it encountered criticism for its handling of the Equitable Life closure.[313] Thereafter, the agency became more aggressive in the regulation of the insurance sector, but still depended on company managers to prevent wrongdoing.[314] The FSA-UK also began a program of

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307. Andrea Felsted, *Financial Consolidation Held Back by Inconsistent Regulation*, FIN. TIMES (London), July, 13, 2000, at 2; *Equitable Life: FSA Response to Baird Report,* Oct. 17, 2001, HERMES Database. This was a change from the previous sector-by-sector analysis used before the creation of the FSA-UK by the various regulatory bodies in London. *Outcome of Consultation on Prudential Regulation Endorses "Single" Regulator,* May 10, 2000, HERMES Database.

308. *The Risk Business*, LAWYER, Sept. 10, 2001, at 21.

309. The agency stated that its single rulebook would still differentiate for different types of businesses and customers. *FSA Plan & Budget for 1999/2000*, Feb. 3, 1999, HERMES Database. As an interim measure, the old rulebooks were incorporated into a single sourcebook. George Walker, *Regulatory Review 2001*, FIN. REG. INT'L (London), Feb. 2002, *available at* LEXIS, England & Wales, Journals.

310. Davies, *supra* note 306.

311. Walker, *supra* note 309.

312. Maeve Bromwich, *The Watchdog Needs a Firm Hand*, LAWYER, Dec. 2, 1997, at 13.

313. James Mackintosh, *Regulator Faces Rising Tide of Trouble*, FIN. TIMES (London), Oct. 20, 2001, at 16.

314. *Change Ongoing as FSA Gets to Grips with Its UK Financial Markets Role*, INS. DAY, June 26, 2002.

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The FSA-UK also began a program of enforcement actions, imposing fines and banning wrongdoers from trading in London.[315]

Like markets in the U.S., the London markets were affected by the new competition. The London International Financial Futures and Options Exchange ("LIFFE") had become the second largest commodity exchange in the world, behind the Chicago Board of Trade.[316] Nevertheless, market share was fleeing rapidly to the electronic trading systems on Eurex in Germany. In 1998 LIFFE closed its trading floor, abandoning its open outcry system in favor of electronic trading.[317] But it was too late for LIFFE to regain its position, and the exchange was later acquired by Euronext, the continental exchange that had already combined exchanges in Paris, Brussels, Amsterdam, and Lisbon.[318]

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315. One enforcement action involved the manipulation of stock prices on the Swedish Stock Exchange by the "Flaming Ferraris," a group of traders working at Credit Suisse First Boston in London. James Archer, the son of Lord Archer (who was himself in prison for perjury), was a member of this group, which was named after their favorite cocktail. James Archer was banned for life from working in the City by the FSA-UK. Sanctions were also imposed on other members of the group. James Mackintosh, *James Archer Banned from City Trading for Shares Deception*, FIN. TIMES (London), July 28, 2001, at 3. Another enforcement case resulted in a $500,000 fine imposed on PaineWebber International for failing to have adequate anti-money laundering procedures in place. Ernest Beck, *PaineWebber Receives Fine by U.K. Agency*, WALL ST. J., Aug. 23, 2001, at C18.

316. *Futures Exchanges: Everlasting LIFFE*, ECONOMIST, July 5, 1997, at 73.

317. Alan Cowell, *London Futures Exchange to Reorganize*, N.Y. TIMES, Nov. 3, 1998, at C4; *London Exchange Begins Electronic Trading System*, WALL ST. J., Dec. 1, 1998, at C17. As one source notes:

> CBOT was once the dominant global futures market, but Eurex now occupies that position. . . . [T]he Swiss-German market managed in the first seven months of 2002 to expand on its global leadership position. During this period, it managed a total of 445 million contracts, up 20% on the first seven months of 2001. Its main European rival, the Euronext/Liffe axis, managed 419 million contracts; Chicago Mercantile Exchange 319 million contracts; and CBOT 186 million contracts.

Eurex Aims to Open Up U.S. Market, HANDELSBLATT (Eng. version), Aug. 19, 2002, *available at* LEXIS, Global News Wire.

318. LIFFE was acquired by Euronext in 2001. Alex Skorecki, *Exchanges Take First Steps to Alliance*, FIN. TIMES (London), Sept. 5, 2002, at 28.

The London Stock Exchange ("LSE"), Europe's largest, was also dealing with this new competition.[319] The exchange was involved in a major calamity in trying to upgrade its computerized systems and create a paperless settlement system. The unsuccessful project, called "Taurus," caused losses totaling hundreds of millions of dollars.[320] The LSE then created an electronic, order-driven trading system[321] and decided to demutualize and become a commercial company. As a result, the LSE's listing authority was transferred to the FSA-UK.[322] Thereafter, the LSE announced that it was planning to merge with the Deutsche Börse in Frankfurt. The merged company was to be known as iX-International Exchange and was to be linked with the Nasdaq market in the U.S.[323] The proposal was widely criticized and set off a competing takeover effort by the OM Gruppen AB ("OM"), the owner of the Stockholm Stock Exchange.[324] The LSE survived, but was forced to reorganize itself and drop the proposal to merge with the Deutsche Börse.[325]

VII. Financial Services Agency of Japan

Like the U.S. and the U.K., the form of Japan's present regulatory structure is best explained by its history.[326] After World War II, General Douglas MacArthur's Supreme Command re-

319. *See generally* Bradley, *supra* note 250, at 662–64 (describing the LSE and its history).

320. Glenn Whitney, *Giant London Bourse Seeks New Identity and Focus After Costly Project Fails*, WALL ST. J., April 22, 1993, at A11.

321. Sara Calian & Sylvia Ascarelli, *London Launches Big Bang II for Share Trading*, WALL ST. J., Oct. 20, 1997, at A20.

322. FSA, THE TRANSFER OF THE LISTING AUTHORITY TO THE FSA 3 (Dec. 1999), *available at* http://www.fsa.gov.uk/pubs/cp/cp37.pdf.

323. Erik Portanger, *Swedish Concern OM Launches Hostile Bid Valued at $1.19 Billion*, WALL ST. J., Aug. 30, 2000, at A18.

324. OM also supplied support services for other exchanges and trading platforms, including the California Power Exchange. Silvia Ascarelli, *Swedes Set Formal Bid for the LSE*, WALL ST. J., Sept. 12, 2000, at A21.

325. *See generally* Bradley, *supra* note 250, at 697–98 (describing the takeover battle).

326. Japan has been credited with creating the world's first futures exchange. Mark D. West, *Private Ordering in Japan, Private Ordering at the World's First Futures Exchange*, 98 MICH. L. REV. 2574 (2000). Stock markets were organized in 1874 under an ordinance that was based on the rules of the London Stock Exchange. Andrew M. Pardieck, *The Formation and Transformation of Securities Law in Japan: From the Bubble to the Big Bang*, 19 UCLA PAC. BASIN L.J. 1, 7 (2001).

quired the adoption of provisions from U.S. laws regulating finance, including the securities laws and the Glass-Steagall Act.[327] This new legislation established a Securities Commission for the Supervision of Securities Business based on the American SEC.[328] Japan did not permit bank holding companies, but banks became members of the *keiretsu*, i.e., large companies joining in cooperative units with cross-shareholding, which became the dominant force within the Japanese economy after World War II.[329] The Bank of Japan acted as the country's central bank, setting monetary policy, while the Ministry of Finance ("MoF") was responsible for financial policy.[330]

The MoF became a monolithic component of Japanese finance[331] and managed the economy on both a micro and macro level, leaving only a limited central banking role to the Bank of Japan. To secure its position, the MoF abolished the Securities Commission for the Supervision of Securities Business in 1952 and replaced it with its own Securities Bureau.[332] Other aspects of the U.S.-style regulatory system were also abandoned in later years.[333] The MoF then assumed a dual role of regulator and

327. The provisions for securities and banking regulation were set forth in Article 65 of the Japanese Securities and Exchange Law. Hideki Kanda, *Securitization in Japan*, 8 DUKE J. COMP. & INT'L L. 359, 367 (1998).

328. Laurence, *supra* note 281, at 669.

329. *See* Corinne A. Franzen, *Increasing the Competitiveness of U.S. Corporations: Is Bank Monitoring the Answer*, 2 MINN. J. GLOBAL TRADE 271, 292 (1993) (describing the cross-shareholding of the *keiretsu*). The American occupying authorities tried to break up the *zaibatsu*, or cartels, which had controlled Japan's economy before World War II. Gregory D. Ruback, Comment, *Master of Puppets: How Japan's Ministry of Finance Orchestrates Its Own Reformation*, 22 FORDHAM INT'L L.J. 185, 189–90 (1998). They were simply replaced by the *keiretsu*. For a description of the rebuilding of Japan after World War II, see JOHN W. DOWER, EMBRACING DEFEAT: JAPAN IN THE WAKE OF WORLD WAR II (1999).

330. *See generally* Dafei Chen, *Acute Symptoms of Chronic Problems: Japan's Procrastination in Solving Its Bank Crisis, the Current Situation and a Future Perspective*, 9 MINN. J. GLOBAL TRADE 269, 274 (2000).

331. The MoF assumed control of much of Japanese banking during the 1930s. Ruback, *supra* note 329, at 189. During World War II, a Japanese Securities Exchange was created by the government, replacing nine private exchanges. Pardieck, *supra* note 326, at 7.

332. The MoF also created a Banking Bureau and an Insurance Bureau to regulate these industries. An International Finance Bureau conducted oversight of foreign financial activities of private firms. Chen, *supra* note 330, at 274.

333. Laurence, *supra* note 281, at 669.

business promoter.[334] Though it was the sole governmental financial regulator, SROs, including the exchanges and the Japanese Securities Dealers Association, also provided some minimal regulatory functions.[335]

The Japanese economy prospered, experiencing growth rates of 10% a year between 1950 and 1970.[336] The period of growth continued into the 1980s. The Japanese economy was viewed as an "economic miracle," and its manufacturing processes (e.g., "just-in-time") were widely copied. Moreover, the Japanese worker was well disciplined. The average Japanese household had savings of $100,000,[337] much of which was held in postal savings accounts.[338] The high-quality goods produced in Japan penetrated markets everywhere. The U.S. was an especially attractive market, providing easy access, even though Japan's restrictive trade practices were excluding American goods from the Japanese market.

In the 1980s, however, a "bubble economy" developed in Japan. The stock market boomed, and real estate prices more than doubled between 1986 and 1990. Scandals soon unfolded. In the "Recruit Cosmos" affair, Prime Minister Noboru Takeshita resigned after it was discovered that some 160 influential politicians had been given Recruit Cosmos stock at bargain

334. Pardieck, *supra* note 326, at 8. The MoF often placed its senior officials as executives at financial institutions. These institutions also maintained offices at the MoF to further communications. Ruback, *supra* note 329, at 199–200.

335. Pardieck, *supra* note 326, at 24–27.

336. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 278. The recovery of the Japanese economy was aided by grants and loans from the U.S., as well as a defense umbrella. *Id.*

337. Chen, *supra* note 330, at 277.

338. A unique part of the Japanese financial system has been the provision of postal savings accounts by the government. These accounts received high interest rates and were tax sheltered. In 2000, some 20% of all Japanese personal assets were held in postal savings accounts. BROOME & MARKHAM, *supra* note 11, at 958. In 2002, $25 trillion was held in Japanese postal savings accounts. James K. Glassman, *A Growth Season for Japanese Stocks?*, WASH. POST, Apr. 28, 2002, at HO1. The Japanese government used the monies in these accounts to fund its own operations. The postal savings accounts were placed under the supervision of the Ministry of Posts and Telecommunications, rather than the MoF. Richard E. Nohe, *A Different Time, A Different Place: Breaking Up Telephone Companies in the United States and Japan*, 48 FED. COMM. L. J. 307, 314 (1996).

prices in 1986, just before the company went public.[339] In another scandal, the Hanshin Sogo Bank sold a large amount of stock it held in the Tateho Chemical Company the day before the company announced large losses. No wrongdoing was found, to the consternation of many.[340] Nui Onoue, the "Bubble Lady," became famous for borrowing billions of dollars on her restaurants in order to invest in the stock market. The amounts she borrowed were greater than the value of those properties. She had also used forged certificates of deposit for her trading activities. Eventually, the Bubble Lady, who used séances to pick stocks, was sentenced to twelve years in prison.[341]

The bursting of the Japanese economic bubble at the beginning of the 1990s sent the economy into a deep recession that the country is still struggling with today[342] — massive deflation was experienced; the Nikkei 225 index dropped from 39,000 to 11,000; land prices in large cities dropped eleven years in a row; government debt grew to 150% of GDP, as compared with 33% in the U.S.;[343] and bad debt held by Japanese banks grew to some 30% of GDP.[344] The Hokkaido Takushoku Bank failed, the first to do so in Japan since World War II.[345] Nineteen of Japan's largest banks had capital shortages that threatened their ability to meet the Basel Committees guidelines for international banks.[346] Yamaichi Securities, the fourth largest securities firm in Japan,[347] also failed. Yamaichi had hid its losses in

339. *Ex-NTT Chief Found Guilty in Recruit Scandal*, L.A. TIMES, Oct. 9, 1990, at 3.

340. Laurence, *supra* note 281, at 670.

341. Stefan Wagstyl, *Bank Chief in Japan's Turbulent Years*, FIN. TIMES (London), Jan. 6, 2000, at 12; Robert Thomson, *Institutions in Dock Beside Bubble Lady*, FIN. TIMES (London), Oct. 6, 1992, at 6.

342. The Bank of Japan introduced a zero interest rate policy as a way of putting the economy back on its feet. Ken Belson, *World Business Briefing Asia: Japan: Monetary Policy Unchanged*, N.Y. TIMES, June 13, 2002, at W1.

343. Glassman, *supra* note 338.

344. *Time to Wake Up*, ECONOMIST, Sept. 26, 1998, at 21.

345. Eric C. Sibbitt, *A Brave New World for M&A of Financial Institutions in Japan: Big Bang Financial Deregulation and the New Environment for Corporate Combinations of Financial Institutions*, 19 U. PA. J. INT'L ECON. L. 965, 967 (1998).

346. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 269.

347. The Bank of Japan bailed out the Yamaichi firm in 1965 by agreeing to provide an unlimited amount of loans. 2 MARKHAM, A FINANCIAL HISTORY OF

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off-book accounts, apparently with the knowledge of at least one MoF official.[348] In the early 1990s there were a series of "loss compensation" scandals, in which it was discovered that the country's four largest brokerage firms were covering the trading losses of important clients and politicians.[349] In 1997, the nation's largest securities firm, Nomura, became mired in scandal, after it was discovered that the firm had covered the trading losses of a gangster and engaged in widespread abusive sales practices.[350]

The Japanese government took several steps to deal with this deteriorating situation. The Japanese Diet passed the Financial Reform Act of 1992, which allowed the MoF to establish capital requirements for banks and allowed banks to own securities affiliates. The act also aimed to further competition among financial institutions. Furthermore, a Securities Exchange and Surveillance Commission ("SESC") was created in 1992 to police the securities markets.[351] This legislation ostensibly reduced the MoF's role as the director agency for the placement of financial resources.[352] In application, however, the MoF remained firmly in control of financial services firms and the SESC.[353] Greater reform was attempted in 1996 by means of a "Japanese Big Bang" that sought to emulate the one in the U.K. and deregulate Japan's financial services. The Japanese Big Bang tried to ease market entry and remove non-

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THE U.S., *supra* note 15, at 343. When the firm failed in 1997, it owed the Bank of Japan $3.95 billion. Three executives were arrested by Japanese authorities. Merrill Lynch bought the Yamaichi securities operations, but lost several hundred millions in dollars over the next few years from that investment. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 268. Merrill Lynch ended up closing most of those operations. David Ibison, *Japan Refuses to Offer Up Easy Money For Foreign Banks*, FIN. TIMES (London), July 2, 2002, at 31.

348. Michiyo Nakamoto, *Prosecutors Raid Industrial Bank of Japan*, FIN. TIMES (London), Feb. 10, 1998, at 6.

349. *See generally* Masahisa Ikeda, *The Legality of Compensating Investors in Japanese Securities Market*, 33 HARV. INT'L L.J. 592 (1992) (describing these scandals).

350. David Ibison, *A Banking Star is Brought to Earth,* FIN. TIMES (London), Aug. 8, 2002, at 15.

351. Pardieck, *supra* note 326, at 9.

352. Sibbitt, *supra* note 345, at 987–89.

353. Chen, *supra* note 330, at 276.

competitive practices.[354] Commissions were unfixed. The plan was formulated by a Financial System Research Council to allow banks, insurance companies, and brokerage firms to compete with each other without the prior restrictions that had kept these sectors separate.[355] The government also announced a "Total Plan" to deal with the mass of non-performing debt in the economy and to dissolve bankrupt companies.[356] Although public funds were used to shore up shaky banks, Japan's banks still maintain some $1.3 trillion in bad debts.[357]

Another scandal arose after the Tokyo Prosecutor's Office staged a large-scale raid involving 100 investigators on the MoF offices in 1998.[358] The Prosecutor was seeking information on bribes in the form of lavish entertainment and discount loans allegedly paid to MoF bank examiners by those being examined.[359] Two examiners were arrested and a third committed suicide.[360] More legislation followed in the form of a Financial Reconstruction Law for failed financial institutions and a Financial Early Strengthening Law that allowed public funds to be used to shore up weak or failing banks. These laws were to

354. Ruback, *supra* note 329, at 217.

355. Jessica C. Wiley, Note, *Will the "Bang" Mean "Big" Changes to Japanese Financial Laws*, 22 HASTINGS INT'L & COMP. L. REV. 379, 380, 394 (1999). Under existing regulations, strict separation of securities and banking was required — even separate entrances were required for a firm with banking and securities operations in the same building. Despite the Big Bang goal of removing such restrictions, they were apparently still in place in July 2002. *Mizuho to Open One-Stop Money Shop*, ASAHI SHIMBUN, July 17, 2002. *See also Yanagisawa Panel Call for Promotion of Market Functioning*, JAPAN WKLY. MONITOR, July 8, 2002, *available at* LEXIS, IACNWS 88685779 (advocating fewer regulatory distinctions among securities, banking, and insurance).

356. Chen, *supra* note 330, at 278.

357. *Hampered*, ECONOMIST, July 13, 2002 (Finance & Economics) [hereinafter *Hampered*].

358. Andrew Chin, *Spoiling the Surprise: Constraints Facing Random Regulatory Inspections in Japan and the United States*, 20 NW. J. INT'L L. & BUS. 99, 99–101 (1999)

359. *Japan's Mighty Ministry Trembles*, FIN. TIMES (London), Jan. 27, 1998, at 4.

360. Ruback, *supra* note 329, at 211. Eventually, 112 MoF officials were sanctioned, along with six of Japan's largest banks. Chin, *supra* note 358, at 100.

be administered by a five-member governmental body called the Financial Reconstruction Commission.[361]

The SESC was transferred out of the MoF in 1998, along with an independent Financial Supervisory Agency, which was succeeded by the Financial Services Agency ("FSA-Japan") in 2000.[362] The FSA-Japan was also given the power, previously held by the MoF, to set securities policy and to regulate securities and banking. The SESC continued its operations under authority from the FSA-Japan, which in turn was supervised by the Financial Reconstruction Commission.[363] More reform legislation was adopted: the ban on holding companies was removed,[364] and consumer protection was enhanced through the Law Concerning the Sale of Financial Products.[365]

Some have expressed concern that all of these reforms may not have accomplished very much. The SESC lacked strong enforcement mechanisms[366] — it is only an investigative agency.

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361. *Japan's Financial Sector Reform: Progress and Challenges*, Hakuo Yanagisawa, Minister for Financial Services Japan, Address before the Financial Services Authority (Sept. 3, 2001), *available at* http://www.fsa.go.jp/gaiyou/gaiyoue/presen/20010903.html.

362. Securities & Exchange Surveillance Commission, *History and Functions*, *at* http://www.fsa.go.jp/sesc/english/news/others/20010723.htm (last visited Nov. 18, 2002). The Financial Supervisory agency was merged with the MoF Financial System Planning Bureau to form FSA-Japan. Masaharu Hino, On the Establishment of the Financial Services Agency, Address Before the Bank of England (Sept. 2000), *available at* http://www.fsa.go.jp/gaiyou/gaiyoue/presen/p2000913.html [hereinafter Hino Address]

363. The Financial Reconstruction Commission quickly encountered scandal, and critics charged that it was maintaining the insular and clubby approach of the MoF. *A Loss of Appetite*, ECONOMIST, Sept. 16, 2000 (Japanese Financial Regulation) [hereinafter *A Loss of Appetite*]. The FSA's organization and role in the government is a somewhat confusing one. *See* FSA, *About the Financial Services Agency, Organization* (Jan. 2002), *at* http://www.fsa.go.jp/info/infoe.html.

364. Sibbitt, *supra* note 345, at 993–94.

365. Adopted in 2000, this statute required greater disclosures to customers purchasing financial products. Pardieck, *supra* note 326, at 69–70. A Consumer Contract Act that was also passed in 2000 allowed customers to rescind contracts if they were misinformed about the nature of the transaction and precluded broad disclaimers of liability. *Id.* at 74–78.

366. The SESC chairman promised to "Kick out Rogue Broker-Dealers" and "show up our presence" through enforcement actions. Takeo Takahashi, New Chairman, Inaugural Address (July 23, 2001), *at* http://www.fsa.go.jp/sesc/english/news/others/20010723.htm. The SESC was investigating the manipulation of stock prices by derivative firms trying to avoid paying a bonus cou-

The SESC has no authority to impose sanctions, but may refer matters for sanctions. In practice, however, few referrals have been made to date.[367] In 2001, the SESC had a relatively small staff, at least in comparison to the SEC in the U.S.,[368] and most of them had been transferred from the MoF.[369] To be sure, the MoF does appear to retain some policy control.[370] FSA-Japan also experienced a faltering start. When FSA-Japan did try to take aggressive action by urging vast bad debt write-offs, many small and medium-sized companies went bankrupt.[371] FSA-Japan then eased off, pressuring the banks and using public funds to save the Daiei supermarket chain and Koizumi, a construction company, both of which had massive amounts of bad debt. However, there were no bailouts for small companies.[372] The government nationalized the Long-Term Credit Bank of Japan and the Nippon Credit Bank, after these institutions could no longer be kept afloat.[373] Public funds were also injected into all but one major bank.[374]

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pon on Reverse Convertible Bonds. Press Release, SESC, An Annual Announcement of Activity (Sept. 3, 2001), *available at* http://www.fsa.go.jp/sesc/english/news/others/20010903.htm. In 2000, the SESC filed only five cases with the prosecutor's office and made thirty-four recommendations for disciplinary actions to FSA-Japan. *Id.* Between 1992 to June 2001, the SESC made 188 recommendations to FSA-Japan for disciplinary actions. SESC, *What We Do* ¶ 5, *at* http://www.fsa.go.jp/sesc/english/actions/actions_menu.htm (last visited Jan. 30, 2003).

367. Pardieck, *supra* note 326, at 9–14.

368. The SESC staff is about one tenth the size of the SEC. Phred Dvorak, *Walking Wounded, One Reason Stocks in Japan Stay Low: Zombie Companies*, WALL ST. J., Aug. 28, 2002, at A1; Pardieck, *supra* note 326, at 86; Ruback, *supra* note 329, at 226. The SESC has disputed this contention, noting that it has a much smaller universe to regulate than the SEC in the U.S.. Laurence, *supra* note 281, at 677–78. The SESC is composed of a three member commission and has eleven regional offices. SESC, ORGANIZATION, *available at* http://www.fsa.go.jp/sesc/english/aboutsesc/aboutsesc02.pdf (last visited Mar. 20, 2003).

369. Chen, *supra* note 330, at 269, 285.

370. Ruback, *supra* note 329, at 223–24.

371. *Review*, ASAHI SHIMBUN, July 17, 2002.

372. *Hampered*, *supra* note 357; *Review*, ASAHI SHIMBUN, July 17, 2002.

373. The remaining assets of these banks were sold. Former management of both banks were being prosecuted. Several financial institutions were also put into bankruptcy, a rarity in Japan. Hino Address, *supra* note 362.

374. Hakuo Yanagisawa, *Japan's Financial Sector Reform: Progress and Challenges*, Address Before the Financial Services Authority, London (Sept. 3, 2001), *at* http://www.fsa.go.jp/gaiyou/gaiyoue/presen/p20010903.html.

FSA-Japan announced that it was undertaking inspections of large troubled banks in order to address their bad debt problems.[375] The project was supposed to be a "Japanese sword" for dealing with the problem, but the result was largely to shore up some troubled banks.[376] Critics claimed that FSA-Japan was "whitewashing" the bad debt problem in Japan.[377] After downgrading Japan's debt, a credit rating agency claimed that FSA-Japan was engaging in regulatory forbearance as a way to aid the economy "in the hope that something will turn up."[378] The agency was waffling on reform in other areas. Japan dropped its insurance guaranty for customer funds held in time deposit accounts, limiting claims to about $83,000. This was intended to assure more market discipline, but it instead raised concerns that funds would be pulled out of already unstable institutions, weakening them further.[379] When a similar proposal limiting deposit insurance on ordinary deposit accounts met political opposition FSA-Japan started backtracking.[380] It then extended government insurance on some deposits, a breach of its promise to eliminate unlimited guarantees.[381]

FSA-Japan seemed to be retreating from promised reform measures in the insurance industry and was stalling on allowing commercial banks, such as the one sought by Sony, to be licensed.[382] The Japanese government continued the old MoF role of trying to manage the economy in other ways. Most re-

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375. FSA-Japan seems to place heavy regulatory emphasis on inspections, a costly and time-consuming form of regulation requiring considerable manpower. FSA, *Financial Services Agency Program Year 2001 Basic Guidelines and Basic Plan for Inspections* (July 30, 2001), *at* www.fsa.go.jp/news/newse/e20010730-1.html.

376. *Tomomi Miyazaki*, ASAHI SHIMBUN, May 1, 2002.

377. *Japan — Can Japan's Banks Clean Up?,* THE BANKER, May 1, 2002.

378. David Ibison, *Bank Regulator Criticized for Lack of Action*, FIN. TIMES (London), June 6, 2002, at 10.

379. David Pilling, *Regulator Drafts Plan for Japanese Bank Mergers*, FIN. TIMES (London), July 11, 2002, at 9; David Pilling, *Japan May Move to Hasten Banking Shake-Up*, FIN. TIMES (London), July 8, 2002, at 7 [hereinafter Pilling, *Japan May Move*].

380. *Another Tokyo Setback*, WALL ST. J., Aug. 28, 2002, at A14.

381. *Japan Set to Break Deposits Pledge*, FIN. TIMES (London), Sept. 5, 2002, at 1.

382. *A Loss of Appetite*, *supra* note 363. The U.S. also rejected the operation of commercial banks such as one proposed by Wal-Mart and Sony in the U.S. when the GLBA was adopted in 1999. Markham, *Banking Regulation: Its History and Future*, *supra* note 4, at 264, 278 n.347.

cently, despite FSA-Japan's push for a market solution, the government suggested that more banks should merge and that it would offer a higher government guarantee to encourage such actions.[383] In fact, several of Japan's largest banks did merge to form colossal enterprises, the largest being Mizuho Holdings, Inc, composed of Daiichi Bank, Fuji Bank, and the Industrial Bank of Japan.[384]

FSA-Japan was accused of trying to manipulate the Nikkei 225 index through short sale restrictions, which were modeled after those of the SEC in the U.S.[385] Like the MoF, FSA-Japan has often been lenient, at least on Japanese banks. For example, FSA-Japan merely issued a warning to a Japanese bank that hid key information from inspectors.[386] FSA-Japan has shown that it does know how to play tough, at least where foreigners are involved. FSA-Japan accused two American firms of improper short sales, in another attempt to support the market.[387] In 1999, the Tokyo branch of Credit Suisse was excluded from engaging in the derivatives business in Japan after several abuses.[388] FSA-Japan denied the consequent claims that it was discriminating against foreign firms.[389]

383. Pilling, *Japan May Move*, *supra* note 379, at 7.

384. Alexandra Nusbaum, *Investment Trust Hopes Lift Tokyo*, FIN. TIMES (London), Jan. 29, 2000, at 24.

385. *Some Securities Dealers Have Already Been Punished for Breaking Body*, ASAHI SHIMBUN, Mar. 19, 2002.

386. *Mizuho Given Warning in May for Misleading FSA*, ASAHI SHIMBUN, June 19, 2002.

387. David Ibison, *Nikkei Was Manipulated by Japan, Say Banks*, FIN. TIMES (London), June 13, 2002, at 1.

388. Michael S. Bennett & Michael J. Marin, *The Casablanca Paradigm: Regulatory Risk in the Asian Financial Derivatives Markets*, 5 STAN. J. L. BUS. & FIN. 1, 26 (1999). A criminal indictment was brought by Japanese prosecutors against the firm for concealing documents. Phred Dvorak & Erik Portanger, *London Division of Credit Suisse is Indicted in Tokyo*, WALL ST. J., Dec. 9, 1999, at A23.

389. Takeshi Uera, *Policies of Japan's FSA Misunderstood*, FIN. TIMES (London), June 18, 2002, at 14. Disciplinary action was also taken against JP Morgan by FSA Japan and against Nikko Salomon. Bayan Rahman, *JP Morgan Japan Arm Ban*, FIN. TIMES (London), Mar. 1–2, 2003, at 8; Jason Singer, *Japanese Regulators Penalize Nikko Salomon*, WALL ST. J., Mar. 19, 2003, at B10. American regulators have not been unwilling to employ a heavy hand in disciplining Japanese firms. *See* United States v. Iguchi, 1997 WL 593018 (2d Cir. 1997) (unpublished opinion) A Japanese rogue trader, who lost $1 billion in unauthorized trading, was jailed, and Daiwa Bank, the victim of this em-

The Nikkei 225 Index remains 74% below its high in 1989.[390] An advisory committee to FSA-Japan has recommended that stocks be sold at post offices as a means of shifting corporate financing away from bank loans and towards the equity markets in order to inflate the stock market.[391] The committee also supported a continuing role for the government in bailing out troubled banks.[392] The Bank of Japan followed up that proposal with an announcement that it would be buying the stock of companies held by banks.[393] This was said to be a "shocking" manipulation of the stock market designed for the benefit of the banks.[394] The Bank of Japan, FSA-Japan, and the MoF were said to be at an impasse over policy disputes.[395] On the positive side, the agency was seeking greater public disclosures from firms in precarious financial circumstances.[396] It raised its bank capital adequacy threshold for intervention and correction, but capital levels at Japanese banks were still well below the Basel minimum international standard.[397] FSA-Japan allowed banks to sell life and other insurance and announced that

ployee, was fined $340 million for failing to report the losses promptly to U.S. regulatory authorities. That was then the largest criminal fine in history. *Id.*

390. Phred Dvorak, *Walking Wounded, One Reason Stocks in Japan Stay Low: Zombie Companies*, WALL ST. J., Aug. 28, 2002, at A1.

391. A proposal to reform the postal service was "emasculated." *Another Tokyo Setback*, WALL ST. J., Aug. 28, 2002, at A14. Japanese savings habits remain a matter of continuing concern. "The Japanese have a mammoth $122 trillion in household savings but invest just 4.4% of their financial assets in stocks, compared with about 18% for Americans." Dvorak, *supra* note 390, at A1.

392. *Panel Calls for Shift to Direct Financing*, JAPAN WKLY. MONITOR, July 15, 2002, *available at* LEXIS, IACNWS 89070940.

393. David Pilling, *Dramatic Action by BoJ to Shore Up Banks*, FIN. TIMES (London), Sept. 19, 2002, at 10; Phred Dvorak, *Japan's Central Bank Will Buy Stocks Held by Troubled Lenders*, WALL ST. J., Sept. 19, 2002, at A1. This led to a loss of confidence in the government's bond issues. Ken Belson, *Not Enough Bidders for Bond Auction*, N.Y. TIMES, Sept. 21, 2002, at C1.

394. *Japanese Central Bank Plans to Buy Stocks*, NEWS & OBSERVER (Raleigh), Sept. 19, 2003, at 3D.

395. Ken Belson, *Not Enough Bidders for Bond Auction*, N.Y. TIMES, Sept. 21, 2002, at C1.

396. *FSA Wants Companies to Disclose Vulnerability*, YOMIURI SHIMBUN DAILY YOMIURI, July 5, 2002, at 1.

397. *Watchdog Raises Bank Scrutiny*, ASAHI SHIMBUN, June 27, 2002. Large Japanese banks had capital of about one-fourth of that required by the Basel standard. *Hampered*, *supra* note 357.

it was allowing bank affiliated brokers to do so as well.[398] After some well publicized insurance firm failures, FSA-Japan increased regulatory controls over the industry, requiring, among other things, marked-to-market accounting and increasing solvency margins.[399] At the same time barriers to entry were being lowered, allowing some foreign competition.[400]

VIII. WHICH IS BETTER?

From a distance at least, the regulatory model developed by the U.K. has a great deal of theoretical appeal.[401] The different areas of the financial services industry have been gradually intermingling over the last quarter of a century. The American model of regulating each facet of finance is based on the historical separation of financial services and not on their current status. As Howard Davies, the Chairman of the FSA-UK, noted in answering his own rhetorical question of why his country should move to a super regulator:

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398. *FSA to Allow Bank's Securities Units to Sell Life Insurance*, JAPAN WKLY. MONITOR, June 24, 2002, *available at* LEXIS, IACNWS 87698011. *The Asahi Shimbun and Wire Reports*, ASAHI SHIMBUN, June 21, 2002; *Banking on Deregulation*, INS. DAY, May 3, 2001, at 4.

399. *Japan's FSA Tightens Up Sector Regulation*, INS. DAY, Apr. 26, 2001, at 5. A self-assessment system was implemented for setting reserve requirements. Hino Address, *supra* note 362, ¶ 16. Japanese insurance companies continued to experience a loss in profitability as a result of the disinflation in the economy. *Insurers Must Abandon Herd Mentality*, YOMIURI SHIMBUN DAILY YOMIURI, June 11, 2002, at 1, 1–2. The industry was consolidating. *See Outlook on Japan life Insurers Remains Negative*, PR NEWSWIRE, June 7, 2002, *available at* http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=105&STORY=/www/stroy/06-06-2002/0001742568; *Life Insurers Plan Pension Fund Management Alliance*, BESTWIRE, Apr. 10, 2001. FSA-Japan has allowed mergers of life and non-life insurers, aiding the trend toward consolidation. Bayan Rahman, *Dai-Ichi and Yasuda Moot 316 Billion Dollar Link*, FIN. TIMES (London), Aug. 28, 2000, at 20; *One Result of Japan's Big Bang. . .* , INS. DAY, Oct. 2, 2001, at 9.

400. Charles Garnsworthy, *Life Crisis Prompts Change*, REINSURANCE MAG., May 1, 2002, at 26; *A Growing Influence on the Japanese Scene*, INS. DAY, Dec. 6, 2000, at 7.

401. The super regulator is becoming an increasingly popular model. Germany only recently created a single regulator — the Federal Agency for Financial Services Supervision. G. Thomas Sims, *Germany Wants New Regulator to Boost Confidence*, WALL ST. J., May 2, 2002, at A13. South Korea also created a Financial Supervisory System as a unified regulator. Andrew Ward, *UBS and Merrill Punished for Leaks,* FIN. TIMES (London), Aug. 14, 2002, at 17.

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> Because financial markets move on, the sectoral system put in place in the late 1980s is no longer fit for the purpose at the beginning of the 21st century. The old divisions between banks, insurance companies, securities firms, investment managers, and the rest, do not reflect the way the financial sector is now organized. Banks own insurance companies, and vice versa. Insurance companies own fund managers. The most rapidly growing mortgage bank is owned by a mutual life insurer. Lloyds TSB now incorporates Scottish Widows. What do you call Citigroup, which includes Citibank, Travellers, Salomon Smith Barney and, now, Schroders?[402]

Nowhere is this trend more evident than in the U.S.. It is best exemplified by the Chairman's reference to Citigroup,[403] a modern financial services firm that sells products across all business lines.[404] There are few, if any, remaining conventional banks that only take deposits and make loans, surviving on the spread.[405] Merrill Lynch is, for example, not just a broker-

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402. Howard Davies, *Scrutiny has Sharpened Resolve of City Watchdog*, TIMES (London), May 2, 2000, at 26.

403. International financial behemoths such as Citigroup raise other concerns:

> Who regulates Citigroup, the world's largest and most diverse financial institution? With its operations in over 100 countries, selling just about every financial product that has ever been invented, probably every financial regulator in the world feels that Citi is, to some degree, his problem. . . . Yet in a sense nobody truly regulates Citi: it is a global firm in a world of national and sometimes sector watchdogs. The same is true of AIG, General Electric, UBS, Deutsche Bank and many more.

The Regulator Who Isn't There, ECONOMIST, May 18, 2002.

404. Banks now sell 40% of the annuities sold in the U.S.. Jeff D. Opdyke, *A Risk-Free Way to Beat the Dow?,* WALL ST. J., Aug. 28, 2002, at D1.

405. As a 1995 U.S. Treasury memorandum also noted with respect to the traditional banking business:

> The share of total private financial assets held by insured depository institutions has declined sharply, from about 60 percent in 1970 to less than 35 percent today.
>
> Only 15 percent of all financial assets held by households and the non-profit sector in 1994 was accounted for by insured deposits.
>
> Recent data show that, of the 20 largest financial firms in the United States. Only 5 are commercial banks. Moreover, a number of diversified financial services firms own non-bank, thrift institutions, or industrial loan companies.

dealer. It sells insurance, provides bank services, manages portfolios, and engages in a wide range of financial services that compete with those of the large banks.[406]

The single regulator approach provides FSA-UK with the ability to approach financial regulation from a larger perspective. The agency is able to focus on those objectives and to decide how they can be met in the most rational fashion, rather than through competition with other regulators.[407] As a single regulator, the FSA-UK can be refreshingly candid about what it

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> The differences between the products of banks and non-bank financial firms have been increasingly blurred. The emergence of similar products by different firms operating under different regulatory regimes results in complicated competitive and regulatory issues.
>
> A number of commercial banks engage in little or no traditional banking — funding commercial loans with deposits. Rather, they specialize in trading activities, consumer finance, or fee-based services.
>
> Capital markets have become increasingly globalized, and financial markets in different countries have become more interdependent.
>
> Technological innovations such as remote banking and digital cash daily redefine the nature and delivery of financial services and the respective roles played by bank and non-bank firms. For example, the date processing firm EDS is the second largest owner/operator of ATMs in the U.S.

DEPARTMENT OF THE TREASURY, MEMORANDUM FOR MEMBERS OF THE SECRETARY'S ADVISORY COMMISSION ON FINANCIAL SERVICES FROM JOAN AFFLECK-SMITH, DIRECTOR, OFFICE OF FINANCIAL INSTITUTIONS POLICY (Oct. 23, 1995) [hereinafter DOT, MEMO ON FINANCIAL SERVICES].

406. As Merrill Lynch notes:

> The financial services industry continues to be affected by an intensifying competitive environment, as demonstrated by consolidation through mergers and acquisitions, competition from new and established competitors using the Internet or other technology, and diminishing margins in many mature products and services. The trend of consolidation of commercial and investment banks made possible by the Gramm-Leach-Bliley Act has also increased the competition for investment banking business through the use of lending activities in conjunction with investment banking activities.

MERRILL LYNCH, 2001 ANNUAL REPORT 17, *available at* http://www.ml.com/annualmeetingmaterials/annrep2001/ar/discussion.html.

407. The FSA-UK has taken this ability seriously and has thoughtfully addressed its statutory objectives and how they can be met. FINANCIAL SERVICES AUTHORITY, 2002 A NEW REGULATOR FOR A NEW MILLENIUM (Jan. 2000), *available at* http://www.fsa.gov.uk/pubs/index-chrono-2000.html.

is able to accomplish, advising the public that it "does not aim to prevent all failure" and that it "recognizes the proper responsibilities of consumers themselves and of firms own management and the impossibility and undesirability of removing all risk and failure from the financial system . . . ."[408] There is, however, an important factor present in the U.K. that is not found in Japan, the other super regulator country considered in this Article. There is a long and well developed culture in the U.K. of avoiding governmental interference in business.[409] The FSA-UK, while reflecting a political demand for more regulation, is still a non-governmental body that remains an extension of the City's cultural abhorrence to intrusive regulation. London has learned from long experience that, while there will always be scandals and failures, each should be viewed as *sui generis* and dealt with accordingly.

Japan, in contrast, has a regulatory culture of intervention and economic management. The MoF managed the economy with some success in its early stages; Japan even threatened the U.S. competitively.[410] That MoF model, while successful during the growth period of the Japanese economy, failed as the economy became more complex.[411] The insular nature of Japan's financial structure crumbled in the face of global competition that the country could no longer avoid. Mounting scandals, which were unearthed as the economy declined, required that the MoF be removed at least from the front door of regulation. The creation of FSA-Japan gave lip service to finding market

408. INTRO. TO THE FSA, *supra* note 295, at 7.

409. *See* Schooner & Taylor, *supra* note 275, at 613 (describing the reasons for this hands-off culture).

410. *See generally* DAVID HALBERSTAM, THE RECKONING (1986) (describing the competitive threat to American automobile manufacturers from Japan).

411. This is a point best left to the economists, but it seems that managed and command economies may do well in their early growth stages and then collapse as the economy becomes too complex for such management. The most extreme example is the former Soviet Union. The country's economy recovered to its pre-World War II levels within five years of the conclusion of that conflict despite the damage wreaked by the Germans. Its economy continued to expand for a time before falling apart. At the end, eighteen million bureaucrats were trying to substitute for a market. The result was shortages in 234 out of 277 basic consumer goods. Alexander Belozertsev & Jerry W. Markham, *Commodity Exchanges and the Privatization of the Agricultural Sector in the Commonwealth of Independent States — Needed Steps in Creating a Market Economy*, 55 LAW & CONTEMP. PROBS. 119, 128–31 (1992).

solutions to the economic malaise in Japan, but that agency still seems to cling to the culture of managing the economy by supporting large banks and resisting foreign competition. Consequently, the Japanese super regulator model does not seem to be a desirable one to mimic. A developed economy is simply too complex to be managed by bureaucrats, no matter how brilliant.

This brings us to the American competitive regulatory model. The GLBA enshrined the concept of "functional" regulation, which means that a diversified financial services firm that has a bank in its holding company structure will have a plethora of regulators with substantively different and sometimes conflicting regulatory requirements. Such a firm will face regulation from several bank regulators, including the Federal Reserve Board, the FDIC, and either the Comptroller of the Currency or a state bank regulator. The firm will also be regulated by the CFTC and the SEC, plus one hundred or more state securities and insurance commissions.[412] The firm will further be subject to regulation by various self-regulatory organizations, including NASDR, probably the NYSE, various options exchanges, the National Futures Association, and possibly various contract markets such as the Chicago Board of Trade. If that were not enough, such entities must also undergo the scrutiny of an ever-increasing list of "gatekeepers," including accountants, lawyers, analysts, NRSROS, and outside directors. The Federal Trade Commission is using its cold calling and false advertising regulatory powers to appear in joint "sweeps" with the SEC and CFTC.[413] There are also state attorney general wolf packs and an increasingly aggressive Justice Department that will happily destroy a large firm and devastate its employees' careers because of the wrongdoing of a few.[414] What exactly is functional about this morass?

The American regulatory culture is an aggressive one, reflecting a strong anti-business bias.[415] In the context of the SEC and

412. The District of Columbia must also be counted.

413. *See supra* note 259. The FTC was also seeking a $215 million fine from Citigroup, perhaps the most regulated firm in the world, for predatory lending practices. *Citigroup to Settle Lending Case*, N.Y. TIMES, Sept. 20, 2002, at C12; *What's News*, WALL ST. J., Sept. 6, 2002, at A1.

414. *See infra* notes 424–25, 433 and accompanying text.

415. The author has tried to catalogue this cultural bias elsewhere. It can be traced at least to Thomas Jefferson's antipathy to the northern merchants, and was fueled by Andrew Jackson's destruction of the Bank of the U.S. and

CFTC, there are numerous instances of this aggressiveness. Insider trading prosecutions are a prime example. Such charges have not been vigorously pursued in Tokyo or London.[416] The Sumitomo copper case also makes an interesting case study. Sumitomo Corp., a large Japanese trading company, was the victim of a rogue trader who was manipulating the world copper market, mostly through trading conducted in the London markets. The unauthorized activities of this trader, Yasuo Hamanaka, cost Sumitomo $2.6 billion in trading losses, a rather severe punishment in and of itself. Despite the fact that Hamanaka's trading had only a tangential relationship to the U.S., the CFTC brought a case against Sumitomo and fined

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the excesses of the Robber Barons. The harsh competition practiced by the trusts also gave it strength. The "populists," the "muckrakers," and the "money trust hunt" laid the groundwork for the New Deal financial legislation that was anti-business in its thrust and which is popularly viewed, without any apparent justification, to have saved America during the Great Depression. The questionable payment scandals of the 1970s and the insider trading scandals of the 1980s caused a rebirth of the anti-business movement in American culture. *See* 1–3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* notes 15, 42, 274. Now Enron has freed these demons once again.

416. An FSA-UK official stated that he could "count the number of U.K. insider-trading cases on the fingers of one hand, 'and still have a few to play with.'" Anita Ragahaven et al., *Europe's Police Are Out of Luck on Insider Cases*, WALL ST. J., Aug. 17, 2000, at C1. Japan was even more of an "insider's paradise." Laurence, *supra* note 281, at 670. Japan has been prodded into being more vigorous against insider traders. Between 1992 to June 2001, the SESC filed thirty-six cases with the prosecutor, thirteen of which involved insider trading. Securities and Exchange Surveillance Commission, *What We Do*, *at* http://www.fsa.go.jp/sesc/english/actions/actions.htm (last visited Jan. 30, 2003). These regulators have also responded to other SEC initiatives. The FSA-UK adopted the SEC view on selective disclosure to analysts. *See, e.g.*, Silvia Ascarelli, *U.K. to Bolster Rules That Bar Select Briefings with Analysts*, WALL ST. J., Oct. 26, 2000, at A21 (describing the FSA-UK's views). In doing so, however, the FSA-UK allowed its firms to take corrective actions and noted that market forces were requiring the change in any event. Randall Smith & Aaron Luchetti, *How Spitzer Will Affect Wall Street*, WALL ST. J., May 22, 2002, at C1. The FSA-UK has also been more gingerly than the SEC in its approach to the regulation of electronic communications networks. Silvia Ascarelli, *U.K. Regulators Seek Advice on Ways to Oversee Electronic Trading*, WALL ST. J., Jan. 24, 2000, at C22; Mark Atherton, *FSA Reviews Share Deal Rules*, TIMES (London), Apr. 26, 2001, at 28. Both Japan and the U.K. have expressed concern that the Sarbanes-Oxley legislation has gone too far and could adversely affect their companies. *See, e.g.,* Edward Alden, *Japan Joins Chorus of Disapproval on New U.S. Corporate Rules*, FIN. TIMES (London), Aug. 1, 2002, at 6.

the company a record amount of $150 million. Japan and the U.K. only piggybacked onto this action. Japan prosecuted the rogue trader. Most of the trading at issue took place in London, but the FSA-UK asked only for its costs in investigating the matter, some $8 million.[417]

The Enron affair and subsequent accounting scandals underscore the weakness and instability of this competitive regulatory culture, particularly when politics intervene.[418] Competitive regulation did not stop any of these massive accounting frauds.[419] The hysteria attending the Enron affair in Congressional hearings was another appalling chapter in our financial history.[420] Berating and badgering witnesses, demanding only

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417. Aaron Lucchetti, *CFTC Fines Sumitomo a Record $150 Million*, WALL ST. J., May 12, 1998, at C19. *See also* In the Matter of Sumitomo Corp., [1996–1998 Transfer Binder] Commodity Futures L. Rep. (CCH) ¶ 27,327 (C.F.T.C. 1998) (CFTC consent decision).

418. These scandals turned on various schemes to manage or falsify earnings, a concern that has been around for decades. George Getschow, *Paper Profits, Slick Accounting Ploys Help Many Companies Improve Their Income*, WALL ST. J., June 20, 1980, at 1. In 1999 — before Enron — the SEC had been investigating managed earnings. Thomas S. Mulligan, *New Wave of Accounting Probes Deepens Fear*, L.A. TIMES, Apr. 4, 2002, at C1. Concern with accounting practices is also an old issue. *SEC Chief Urges Accountants to Improve Self-Regulation or Risk U.S. Intervention*, WALL ST. J., Jan. 4, 1980, at 11. *See also* Charles Stabler, *Accountants' Self-Regulatory Efforts Get SEC Praise, But Further Steps Are Urged*, WALL ST. J., July 6, 1978, at 4 (SEC submits massive 1,300 page report on accounting profession to Congress).

419. *See, e.g.*, Anita Raghavan et al., *Full Speed Ahead: How Enron Bosses Created a Culture of Pushing Limits*, WALL ST. J., Aug. 26, 2002, at A1 (describing guilty plea by an Enron financial officer); Sheila McNulty & Peter Spiegel, *Former Enron Executive Pleads Guilty to Fraud Charges*, FIN. TIMES (London), Aug. 22, 2002, at 23 (same). *See also* Elizabeth Douglas et al., *The Nation, Former Phone Execs Arrested*, L.A. TIMES, Aug. 2, 2002, at A1 (describing the WorldCom fraud).

420. The newspapers joined this lynch mob with enthusiasm. *See, e.g.,* Raghavan et al., *supra* note 419 (describing Enron executives as bad boys who went to strip bars, drove fast cars, and paid $500 per month for a parking spot). Of a kin was an English author's supercilious suggestion that Enron and other accounting scandals might evidence that Karl Marx was correct in claiming that capitalism was victimizing society. Niall Ferguson, *Marx, Niall Ferguson Says Capital's Author was Right about the Class Struggle*, FIN. TIMES (London), Aug. 17, 2002, at 1. The low was reached in the "Women of Enron" photo spread in the August 2002 issue of *Playboy*. *See Women of Enron*, PLAYBOY, Aug. 2002, at 118. At that point, all that was lacking was an article in the *National Enquirer* claiming that the Enron executives were children of aliens from outer space. The gap was filled when the scandal over

yes or no answers to convoluted and complex questions, mocking witnesses and cutting off their answers when it was not favorable to the Congressional inquisitor, and requiring witnesses to take the Fifth Amendment in front of cameras had all the trappings and foulness of a McCarthy era hearing.[421] The SEC

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whether Martha Stewart, the guru of domestic living, had engaged in insider trading in ImClone Stock. The mob positively howled. *See, e.g.,* Holman Jenkins Jr., *Business World: An Autumnal Resolution: Give Martha a Break*, WALL ST. J., Sept. 4, 2002, at A23 (describing the allegations). The scandal over Jack Welch's retirement benefits set off another feeding frenzy. Despite the fact that he had added billions of dollars of value to General Electric, the press was claiming he had acted improperly after it was revealed in a divorce case that he was given perquisites valued at about $2.5 million per year. Those perks included such things as tickets to sporting events, and the opera, a small consulting fee, an apartment, office, and use of a corporate jet, all of which had been negotiated with outside directors and disclosed. *See, e.g.,* Matt Murray et al., *GE Pact With Welch Raises Eyebrows*, WALL ST. J., Sept. 9, 2002, at B4; Jack Welch, *My Dilemma and How I Resolved It*, WALL ST. J., Sept. 16, 2002, at A14. These two celebrities were not the only targets of the press. One of the more silly charges claimed that a Merrill Lynch analyst was somehow corrupted by an exchange of wine and champagne with the CEO of Tyco, who was later indicted for tax evasion and looting Tyco. *See, e.g.,* Patrick McGeehan, *Lawyer Says Ex-Merrill Analyst Traded Gifts with Tyco Chief*, N.Y. TIMES, Sept. 14, 2002, at C1.

421. The fact that a great many people seem surprised that a severe market downturn would expose abuses is beyond comprehension, particularly after an unprecedented ten-year bull market that predictably covered up a multitude of sins. The dismay expressed for the 5,000 or so laid-off Enron employees and even Enron shareholders also seems somewhat affected, when one considers the fact that Motorola, Nortel, Corning, Lucent, and Procter & Gamble have each laid off tens of thousands of employees in the last few years. There were no cries of outrage when those employees were left without a job. These companies' shares, many of which were held in employee 401(k) accounts, sustained major losses, but there were few cries to lynch the executives. *See, e.g.,* Richard Waters, *Nortel Spasm Causes Pain for Sector Rivals*, FIN. TIMES (London), Aug. 29, 2002, at 1 (describing the continuing problems in the telecom industry). The difference in the case of Enron was the result of several factors that went beyond a concern for fraudulent accounting practices, as serious as they may be. The stock market was falling in 2001, and the Enron collapse was a signal to find a scapegoat for that downturn. This was also a political opportunity. The Democrats could not attack President Bush over the "War on Terror," so they turned to the economy and Enron. The Republicans could not let the Democrats out-Enron them since the coming elections would decide control of Congress by one party or the other. The Republicans became as strident as the Democrats as this quickly turned into an election issue. *See, e.g.,* John Harwood & Shailagh Murray, *Guns and Butter: For Fall Campaigns, a Tension between Economy and Security*, WALL ST. J., Aug. 30, 2002, at A1; Jeff Zeleny, *Democrat Hopefuls Dig in on Economy; Moderates*

joined the witch-hunt, requiring the CEOs of America, guilty or not, to take a loyalty oath to full disclosure by swearing to the accuracy of their company's financial statements.[422] Hastily drafted legislation led to an incredible increase in the SEC's budget and more redundant layers of regulation were added.[423]

Competitive regulation, at least in a crisis, results in bad judgment of an extreme character. Exhibit A is the Justice Department's indictment and trial of Arthur Andersen, LLP.[424] Tens of thousands Arthur Andersen employees worldwide, far outnumbering the affected Enron employees, were forced to find new jobs even though they did not participate in the alleged wrongdoing of the one individual found responsible for the conviction of the firm.[425] The conviction also badly damaged Enron

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Warn Attacks on Business Could Backfire, CHICAGO TRIBUNE, July 9, 2002, at N9.

Corporate accountability even became an issue in gubernatorial contests, as if the governors could do anything about SEC accounting issues. *See, e.g.*, Randal Archibold, *Cuomo is Saving His Firepower For End of Race, Advisers Say*, N.Y. TIMES, Aug. 22, 2002, at B6 (New York race); Mark Z. Barabak, *Bush Steps Carefully Into State*, L.A TIMES, Aug. 23, 2002, at A1 (California race). Of course, corporate accountability is not a new issue, having arisen in the questionable payment scandals of the 1970s. *See, e.g.,* Stan Crock, *Manager's Journal*, WALL ST. J., Mar. 13, 1978.

422. *See* Andrew Hill, *Wall Street's Next Focus is 'Oath' Deadline*, FIN. TIMES (London), Aug. 5, 2002, at 19. In the end, only sixteen of the 691 reporting companies required to take this oath were unable to certify their financial statements. Krissah Williams, *16 of 691 Firms Missed Deadline; SEC is Undecided on Consequences*, WASH. POST, Aug. 22, 2002, at EO3.

423. *See supra* notes 71–80 and accompanying text.

424. Arthur Andersen, LLP was Enron's auditor. The accounting firm was indicted and later convicted of obstructing justice by trying to cover up certain improper accounting practices. *See generally* ENRON CORP., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (2002). Arthur Andersen had also been found liable in some earlier accounting scandals, and the company was effectively destroyed after its conviction. *See, e.g.,* Flynn McRoberts, *Verdict No Boon for Enron Plaintiffs*, CHI. TRIB., June 18, 2002, at 1 (describing effects of verdict).

425. The verdict in the Andersen case was extremely bizarre. The Justice Department had charged Arthur Andersen with obstruction of justice based on document shredding by an accountant in the Houston office, who had pled guilty to wrongdoing. The jury, however, convicted the firm on the basis of a memorandum written by an Andersen attorney on another issue. *See, e.g.,* Kurt Eichenwald, *Andersen Team Weighs Asking Judge to Undo Guilty Verdict*, N.Y. TIMES, June 19, 2002, at C1. The Andersen attorney had testified at length before Congress concerning the memorandum in question. The issue was again raised during the Andersen trial, after the government's star wit-

investors. A settlement proposal by Arthur Andersen of $750 million, to be paid substantially out of future revenues, was presumably only an opening bid and was rejected by class action plaintiffs; it was reduced to $375 million as the government's indictment approached. That too was taken off the table after the conviction, and plaintiffs are now negotiating a $60 million settlement from the parent company of Arthur Andersen, LLP.[426] Further recoveries from the convicted auditing firm are problematic, since it is forfeiting its right to practice, cutting off future revenues that could have been used to compensate investors and Enron employees.[427]

The disclosure of other accounting frauds witnessed Gestapo-like dawn raids on the homes of corporate executives. Businessmen, whose only violent act in their entire lives was perhaps an attack on a tennis ball, were manacled and frog-marched before news cameras during their "perp walk."[428] This was a particularly sordid adjunct to this whole affair.[429] The

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ness turned out to be favorable to the defense. The Andersen attorney, however, was kept off the stand and could not testify in Andersen's defense because the Justice Department had sent her a target letter. *See, e.g.,* Greg Burns, *Who is Nancy Temple?*, NEWSDAY, June 30, 2002, at FO1.

426. Forty million dollars of this amount was for Enron investors and the rest is for creditors. Peter Spiegel, *Andersen Worldwide in $60 Million Settlement over Enron*, FIN. TIMES (London), Aug. 28, 2002, at 17.

427. Mitchell Pacelle & Cassell Bryan-Low, *Andersen Worldwide Sets Likely Deal*, WALL ST. J., Aug. 28, 2002, at C1. The frenzy over the corporate scandals arising from the Enron debacle cost the American economy an estimated $35 billion, an amount equal to a rise in oil of $10 per barrel of oil. *World*, FIN. TIMES (London), Sept. 5, 2002, at 1.

428. WorldCom and Adelphia executives were among those given the "perp walk" treatment. *See, e.g.,* Joshua Chaffin et al., *Ex-WorldCom Chiefs Arrested*, FIN. TIMES (London), Aug. 2, 2002, at 1. The manacling and parading of the seventy-eight year old non-violent founder of Adelphia before the assembled press and cameras was particularly obscene, drawing a protest from the New York Civil Liberties Union. *See, e.g.,* Fred O. Williams, *Adelphia Creditors Object to Rigas Loans*, BUFFALO NEWS, Aug. 14, 2002, at B5. *See also* Lauro v. Charles, 219 F.3d 202 (2d Cir. 2000) (staged "perp walk" violated Fourth Amendment).

429. *See Those CEO Perp Walks*, WALL ST. J., Aug. 20, 2002, at A18 (objecting to this practice); Herbert J. Hoelter, *The Corporate Scandals*, NEWSDAY, Aug. 25, 2002, at BO4 (same). In contrast to the treatment given these executives, a federal judge has held the New York City government in contempt for not providing hearings to inmates previously found with weapons before handcuffing them for transportation. Such inmates must be given an opportunity to show they are not violent before they are shackled and must be al-

pillory was an ancient punishment that has been long banned for all crimes, except, it now appears, for financial ones.[430] A conviction is not even required before this punishment is applied to corporate executives. If this were not enough, New York Attorney General Eliot Spitzer showed up to conduct his own sideshow,[431] demanding a $100 million fine from Merrill Lynch before turning to others in an effort to create a regula-

lowed to establish whether the shackling is harmful to their health. Fines imposed on the city for violating those requirements are to be credited to the inmates' own accounts. *See, e.g.*, Cerisse Anderson, *Correction Department Found in Contempt Over Handcuffing*, N.Y. L.J., Sept. 27, 2002, at 1.

430. The pillory was a popular punishment meted out by the Star Chamber in England for economic crimes. For example, in 1630, an individual found guilty of forestalling, (i.e., holding goods off the market in hopes of creating a shortage and causing prices to rise), was required to stand in the pillory at New Gate Market with a sign affixed to his hat identifying his crime. REPORTS OF CASES IN THE COURTS OF STAR CHAMBER AND HIGH COMMISSION 42–43 (Samuel Rawson Gardiner ed., 1965). The long abolished medieval crimes of engrossing, regrating, and forestalling have also been brought back to punish corporations. *See, e.g.,* Sheila McNulty, *FERC Judge Says El Paso United Acted Illegally in Energy Crisis*, FIN. TIMES (London), Sept. 24, 2002, at 1 (Administrative Law Judge at Federal Energy Regulatory Commission finds company withheld supplies from market in order to obtain higher price).

431. There is some precedent for Attorney General Spitzer's crusades. Indeed, lest you think that the Enron scandal and other recent business contretemps are unique, the American Ice Company scandal at the beginning of the twentieth century had all the elements of those episodes and a pardon scandal to boot. Like Enron, the American Ice Company made large amounts of contributions to politicians and engaged in questionable accounting practices. Like Enron, it was one of the largest companies in the U.S. before it was consumed in scandal. Its monopoly over a vital consumer product at the beginning of the twentieth century was so complete that, at least in comparison, Microsoft might be likened to a benevolent society for the protection of competitors. Like Merrill Lynch, the American Ice Company was the target of a crusading New York attorney general. A presidential pardon of the American Ice Company's president was as controversial as Bill Clinton's pardon of Marc Rich. *See* DAVID HEMENWAY, PRICES & CHOICES, MICROECONOMIC VIGNETTES 189 (3d ed.1993) (describing the American Ice Company scandal). *See also Ice Trust Declared to be Unlawful*, N.Y. TIMES, May 25, 1900, at 1 (describing attorney general's action against the American Ice Company); Robert C. Kennedy, *Hunting the Octopus*, N.Y. TIMES, May 27, 2002, at http://www.nytimes.com/learning/general/onthisday/harp/1006.html (last visited Mar. 20, 2003) (describing the political fight over the Ice Trust Case); *Antitrust Prosecutions*, N.Y. TIMES, Jan. 7, 1912, at 32, 32–33 (survey of antitrust actions by state attorney generals).

tory empire on Wall Street over stock analysts.[432] This led to another campaign by a newly formed wolf pack composed of forty state regulators.[433]

Competitive regulation inevitably means more regulation. For some reason, there are never quite enough regulatory tools in the drawer. Each scandal results in a claim by the regulator

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432. Attorney General Spitzer continued his quest, focusing on Jack Grubman, an analyst at Salomon Smith Barney. Spitzer was investigating a practice called "spinning," i.e., allocating shares in a hot IPO to officers of other clients in order to gain underwriting business. *See generally* Randall Smith & Susan Pulliam, *Buddy System: How a Technology-Banking Star Doled Out Shares of Hot IPOs*, WALL ST. J., Sept. 23, 2002, at A1. Such practices had been the subject of regulatory concern since at least 1997, but there were no headlines in it for the attorney general to intervene while the market was trending upward. Michael Siconolfi, *NASD Warns on "Spinning" IPO Shares*, WALL ST. J., Nov. 24, 1997, at C1; *The Motley Fool Column*, ST. LOUIS POST DISPATCH, Apr. 20, 1998, at BU6. Not to be outdone by Spitzer, Congress announced its own hearings. Tom Hamburger et al., *Salomon IPO Deals Provoke Congress*, WALL ST. J., Aug. 29, 2002, at C1. But Spitzer was already on to bigger game — Citigroup — giving rise to speculation that he may even be after Sandy Weill, the head of Citigroup. Charles Gasparino, *Inquiry Into Salomon Widens to Include Possible Weill Role*, WALL ST. J., Aug. 23, 2002, at A1; Joshua Chaffin & Gary Silverman, *Spitzer Subpoena for AT&T Files*, FIN. TIMES (London), Aug. 24, 2002, at 10.

Spinning was not new to Wall Street. The preferred lists of J.P. Morgan & Co. had been condemned at length in the hearings that led to the enactment of the federal securities laws. 2 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 15, at 145–46. Does this mean all of this regulation has been for nothing? In another remarkable episode, the *Financial Times* of London announced that executives made $3.3 billion before the failure of their companies, which included Enron, WorldCom, and Global Crossings. Len Cheng, *3.3 Billion Dollars for Executives of Failed Companies*, FIN. TIMES (London), July 31, 2002, at 1. Spitzer then announced that he would be investigating those executives for receiving that compensation. Lionel Barber & Gary Silverman, *NY State Attorney Probes Awards to Heads of Bankrupt Groups*, FIN. TIMES (London), Aug. 1, 2002, at 1.

433. The SEC sought to compete by launching its own investigations. *See* Michael Schroeder, *States' Wall Street Probe Bogs Down*, WALL ST. J., Sept. 13, 2001, at C5. The analysts' investigations resulted in a spectacular $1.4 billion joint settlement between several large investment banks and state and federal securities regulators. *See generally* Charles Gasparino, *Analyst Pact is Held Up by Words*, WALL ST. J., Jan. 16, 2003, at C1. Citigroup alone paid $450 million in that settlement. Randall Smith, *Regulators Set Pact, But Some Issues Still Remain*, WALL ST. J., Dec. 23, 2002.

The state attorney generals were also using their new found power to press businessmen for campaign contributions. Tom Hamburger & Michael Schroeder, *The Economy: Spitzer Heads Bill at Campaign Event for Attorney Generals*, WALL ST. J., Oct. 4, 2002, at A2.

involved that it needs more regulatory power and additional rules are adopted, even though library shelves are already filled with statutes and regulations so complex that some law school professors spend their entire careers studying those promulgated by just one agency. A further layer of regulation is always needed after each scandal, even though a simple fraud prohibition would cover nearly every misdeed of concern. But competing agencies have a vested interest in scandals. Scandals allow the regulators to claim they need more resources; they allow the agencies to grow, expand, and compete more forcefully with other agencies.

Of course, we must be careful of what we wish for in life. A single regulator may also seek to expand its powers after a scandal. A single regulator will also undoubtedly use bad judgment in times of crisis. A single regulator could also stifle competition, over-regulate, and cause a loss of competitive position in international markets.[434] It could even try to become a Japanese MoF that seeks to manage the economy by bureaucratic fiat. There would be no competition to prove which regulator can be the most aggressive. There would be no pressure for more resources in order to best a competing regulator.[435]

It may also be argued that competition leads to less restrictive regulation, at least for some market participants. A case in point is the CFTC and SEC. The futures industry has enjoyed low margins, no suitability requirement, little insider trading restrictions, etc. If a monolithic agency with an SEC viewpoint had been in place, such regulatory burdens would probably not have been avoided. Of course, if the single regulator had a CFTC viewpoint, the securities industry's burdens might have been eased. Another argument is that the regulatory wars between the CFTC and SEC diverted the attention of these agencies and allowed the over-the-counter derivatives industry to develop. While this may be true, that development was still

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434. These concerns are described at greater length in Markham, *Banking Regulation: Its History and Future, supra* note 4, at 272–85.

435. A Task Group on Regulation of Financial Services chaired by Vice-President George H. Bush in 1984 cautioned that "[t]hroughout American history, no single government authority has ever been entrusted with regulatory authority over all American banks." BLUEPRINT FOR REFORM, *supra* note 1, at 8.

impeded by the CFTC's defense of the contract market monopoly, which led to much derivatives business moving abroad.

The federal securities laws and the Commodity Exchange Act need to be revisited and revised from the ground up. The regulatory structure imposed in the 1930s was directed at a market far different from the one that exists today.[436] There has been a massive transformation of the financial markets[437] — history has simply outstripped regulation. Financial service firms now cross all product lines. As the Treasury Department has noted: "[I]n light of the changing market shares, the emergence of new financial products and technology, and the disintegration of traditional industry and product lines . . . there needs to be a fundamental reassessment of why and how we regulate financial firms."[438]

Traditional broker-dealers and futures commission merchants are nearly extinct. Broker-dealers are selling insurance, making loans, and looking very much like banks.[439] Broker-dealers, as well as banks, are also selling insurance. Insurance companies are reinventing themselves and becoming diversified financial services firms.[440] Financial engineering has melded commercial and investment banking together, a fact now recognized by GLBA. The futures commission merchant business has evolved into an over-the-counter derivatives dealer. Derivatives and securities products are being blended. Moreover, financial services are becoming a global business, in which American firms must compete with large international firms that cross-sell financial products and are subject to much

436. The regulatory burdens imposed on financial firms are the result of accumulated abuses over the years. The incongruity of many of those regulations is obvious. The non-violators must bear the regulatory burdens for the conduct of the miscreants. The innocent are punished long after the guilty have left the scene.

437. *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215.

438. DOT, MEMO ON FINANCIAL SERVICES, *supra* note 405 (italics omitted).

439. The Merrill Lynch Cash Management Account provides all the benefits of a bank account, as well as those of a brokerage account. *See* Paine, Webber, Jackson & Curtis, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 564 F. Supp. 1358, 1361–62 (D. Del. 1983).

440. 3 MARKHAM, A FINANCIAL HISTORY OF THE U.S., *supra* note 42, at 235–36.

lighter regulation than that found in the U.S.[441] Electronic trading offers further challenges. Another concern is the internationalization of financial services. The confusion, complexity, and costs associated with multiple regulators will certainly place U.S. financial institutions at a severe competitive disadvantage with European and even Japanese firms that operate under a single regulatory umbrella.

Technology is removing much of the structure on which our current functional regulatory system is based. Technology provides a means to bypass traditional intermediaries such as the exchanges, banks, and broker-dealers. Institutional investors may use Instinet or other ECNs to avoid paying the spread on a NASDAQ or a NYSE listed security; securities customers need not pay a large commission to a broker-dealer to execute an order. Rather, it can be done online relatively cheaply. Insurance agents are being circumvented through online purchases.

441. A single regulator would also facilitate coordination among regulators on an international level, a need underscored by the BCCI debacle. The Basel Committee and the International Organization of Securities Commissions ("IOSCO") are currently coordinating such regulation, but their roles are simply placed on top of the mass of regulators in the U.S. The growth of international exchange linkages and electronic trading is also raising the stakes for those regulators. Conflicts are also occurring at the international level. *See, e.g.*, Compliment, *European Companies With UD Listing Fail to Escape Sarbanes-Oxley Act*, *at* http:/www.compliment.com/securities-uk/dailynews/ (last visited Aug. 30, 2002) (describing objection by European Union to requirement that Europeans swear to the accuracy of their financial statements before a U.S. agency); Lydia Adetunji, *SEC Votes to Include Foreign Company Chiefs*, FIN. TIMES (London), Aug. 28, 2002, at 7 (describing SEC indifference to those concerns). The European Union is also posing regulatory challenges through its financial directives that seek a single European market in financial services. *See generally* Jennifer Manvell Jeannot, Comment, *An International Perspective on Domestic Banking Reform: Could the European Union's Second Banking Directive Revolutionize the Way the United States Regulates Its Own Financial Services Industry*, 14 AM. U. INT'L L. REV. 1715, 1732–33, 1738 (1999) (noting that the European Union seeks harmonized regulation as a way to improve the competitive position of banks in member countries); James Mackintosh, *Regulator to Warn Against Brussels Boardroom Plans*, FIN. TIMES (London), July 30, 2002, at 14 (expressing concern that European Union financial directive could weaken corporate governance standards, which are claimed to be higher than those in the U.S.); Erik Portanger, *Politics and Pride Slow Drive for Pan-European Securities Regulator*, WALL ST. J., Aug. 17, 2000, at C7 (discussing need for a pan-European regulator in light of the merger of several European stock exchanges and political obstacles to such regulation).

Loans and other commercial bank services are also being marketed outside traditional bank channels.

There are serious political roadblocks to such an amalgamation. Each current regulatory agency has its own constituency in the industries that have developed competitive positions based on regulatory restrictions.[442] The regulatory agencies themselves will fight fiercely to protect their territory, as demonstrated by the CFTC and SEC conflicts. Congressional committees also have their own jurisdictions to guard. Nevertheless, the functional system of regulation now existing in America needs to be abandoned. In its place, regulatory attention needs to be directed as to who needs regulation and who does not.[443]

For example, regulatory protections of the insurance fund should be uniform and limited. The current excuse for intrusive regulation as being necessary to protect the insurance fund should also be reexamined. Brokerage firms already obtain insurance from the private sector in excess of that provided by SIPC without such intrusive regulation.[444] The concern with systemic risk from large failures of financial institutions could be addressed across sector lines. Value At Risk programs could replace the labyrinth adopted by the SEC and CFTC in their net capital programs. With respect to fraud, the SEC and CFTC already recognize that sophisticated "accredited" investors do not need the same regulatory protections as the proverbial widows and orphans.[445] This approach should be applied to

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442. There have been efforts to combine regulatory responsibilities. For example, the Chicago Mercantile Exchange ("CME") has unsuccessfully proposed the creation of a single department for financial services regulation. CHICAGO MERCANTILE EXCHANGE, FINANCIAL REGULATION FOR THE 21ST CENTURY (1995). The CME proposal was not a particularly radical one, since it would have continued functional regulation in bureaus within the department. *Id.*

443. This proposal is discussed at greater length in Broome & Markham, *supra* note 19, at 776–84.

444. *See* Markham, *Banking Regulation: Its History and Future, supra* note 4, at 284 (discussing private insurance alternatives).

445. "It was understood, even before the enactment of the Securities Act of 1933, that institutional investors did not need the mandatory disclosure system of that Act to protect themselves when acquiring securities. These investors could 'fend for themselves.'" Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 659 (1995). *See also, e.g.*, Regulations and

all financial services. Regulation should be directed at protecting small investors from overreaching and fraud.[446] Accredited investors can take care of themselves in addressing those risks.[447]

Terms Used in Regulation D, 17 C.F.R. § 230.501 (2002) (exempting securities from registration that are sold to accredited investors); CFTC Regulation 17 C.F.R § 4.7 (exempting institutions and wealthy individuals from certain disclosure requirements). The Commodity Futures Modernization Act of 2000 ("CFMA"), Pub. L. No. 106-554, 114 Stat. 2763, is another example where regulatory distinctions are made between large and small firms. Access to derivative transaction facilities ("DTFs") is limited to large institutions, except that a DTF may allow non-institutional access if introduced through an intermediary registered with the CFTC as a futures commission merchant. Such FCMs must, however, have minimum net capital of at least $20 million, assuring a responsible intermediary. 7 U.S.C. § 7a(b)(3)(B)(iv) (2000), *amended by* The Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A.

446. Most violations by broker-dealers, and certainly the most egregious, are committed by small under-capitalized firms that have little to lose if caught and much to gain by fraud and other misconduct. Yet, the SEC makes little distinction between large and small brokerage firms. The large firms must, therefore, bear the costs imposed by the fly-by-night firms. Large firms do not need such intensive regulation. They have an incentive to protect their assets from short-term profits generated by fraud that impose larger long-term costs in damages and reputational loss. Further, they have assets that are available to compensate those injured by employees who go astray.

The federal banking laws contain a limited recognition of the disparity of regulatory problems emanating from smaller, less capitalized institutions. Prior to 1991, all banks paid a uniform 12 cents per $100 of deposits as premiums for deposit insurance. The Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified as amended in scattered sections of 12 U.S.C.), changed that methodology by instituting a system of risk-based deposit insurance premiums that imposed greater costs on institutions that provided the greatest threats to the deposit fund. Banking regulations also utilize the concept of "well capitalized" to allow larger banks to engage in activities that less capitalized institutions would be inclined to engage in without adequate controls. BROOME & MARKHAM, *supra* note 11, at 465 (also noting that the reserve fund for the FDIC is now fully funded for the required reserves and deposit premiums are not presently being collected). For example, banks are also restricted in accepting brokered deposits unless they are well capitalized. 12 U.S.C. § 1831f(a) (2000). The GLBA requires that a bank holding company be well capitalized to be certified as a financial holding company that may engage in a broad range of financial activities outside customary banking channels. 12 U.S.C. § 1843(l)(1) (2000).

447. An official of the Federal Reserve Board has argued that even unsophisticated consumers should be able to buy unregulated products. Indeed, consumers already have a choice of depositing their funds either in an unin-

In sum, a more modern regulatory model should also be based on the following principles:

> (1) Institutions dealing with other institutions should not be subject to intrusive regulation. Institutions are able to watch out for themselves and do not need a government agency to protect them from other members of their industry.
>
> (2) Markets in which only institutions operate should not be regulated. Once again, institutions are able to protect themselves and have the bargaining power to demand information needed for trading.
>
> (3) Unregulated markets should be allowed to operate in which non-institutional customers may gain access through well capitalized intermediaries. Those intermediaries have assets and reputations to protect, which should be sufficient incentive for them to avoid fraud.
>
> (4) Retail customers should be allowed to deal with unregulated intermediaries even in regulated markets, provided that the intermediary is well capitalized and the customer is fully informed of the lack of regulation.
>
> (5) Markets should be allowed to operate, in which intermediaries that are not well capitalized service retail customer orders. But such markets, and those intermediaries that are not well capitalized, will be subject to regulation to assure their financial soundness.

IX. CONCLUSION

The issue of the desirability of a single super regulator over securities and derivatives has been debated since the creation of the CFTC in 1975. There has been little success in achieving any unified regulation. Still, the issue will not recede, and a unified regulator seems to be a sound idea. The model provided by the FSA-UK lends support for such unification, while the model presented by the FSA-Japan shows the weaknesses of such an approach. Should America choose a super regulator, it must be cautious to avoid an agency that will seek to manage the economy or respond to every financial crisis with more in-

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sured money market account or in an insured bank account. Oliver I. Ireland, Fed. Associate General Counsel, New Regulatory Models Institutional vs Functional Regulation, Paper presented at the Annual Chicago-Kent Conference on Derivatives Transactions (Oct. 1999) (on file with author).

trusive regulation. Until then, we must suffer under a competitive system of regulation that is competing for more — and not less — regulation.

THE ROLE OF CENTRAL BANKS IN BANK SUPERVISION IN THE UNITED STATES AND THE UNITED KINGDOM

Heidi Mandanis Schooner[*]

I. INTRODUCTION

Super regulators are the new wave in financial market regulation. "Super," or "integrated," regulators are agencies vested with primary supervisory responsibility for more than one of the three traditional financial sectors — banking, securities, and insurance.[1] Many countries have revamped their regulatory systems to establish a single regulator for all three sectors.[2] One of the most important examples of this trend is the United Kingdom ("U.K."), which, pursuant to the Financial Services and Markets Act of 2000 ("FSMA"),[3] established its Financial Services Authority ("FSA") as an integrated supervisor in 2001. Significantly, just prior to the creation of the FSA, the U.K. had transferred bank supervisory authority from the Bank of England to the Securities Investment Board, which later became the FSA.[4] As a result, the U.K.'s current financial regulatory regime is integrated, but also separated from the central bank.

Meanwhile, across the ocean, Congress awarded the central bank of the United States ("U.S.") an expanded supervisory

* Associate Professor, Columbus School of Law, The Catholic University of America. I thank Professors Patricia McCoy, Steven Schooner, and Dr. Michael Taylor for their valuable contributions and Ed Loughlin for his diligent and able research assistance. I also thank the participants at Brooklyn Law School's symposium, *Do Financial Supermarkets Need Super Regulators?*

1. In this Article, the concept of "integration" is used in a broad sense. It can also be viewed more narrowly. For example, an informal group of integrated regulators (including regulators from Australia, Canada, Denmark, Iceland, Japan, Norway, Singapore, Sweden, and the U.K.) define the term "integrated regulation" to encompass any agency responsible for prudential regulation of both banks and insurance companies. *See* Jeffrey Carmichael, *Experiences with Integrated Regulation*, 6 FIN. REGULATOR 57, n. 2 (2001).
2. *See infra* Part II.
3. Financial Services and Markets Act, 2000, c. 8 (Eng.).
4. *See infra* Part III.B.

role. The Gramm-Leach-Bliley Act of 1999 ("GLBA")[5] established the Board of Governors of the Federal Reserve System ("Federal Reserve") as umbrella regulator for financial holding companies — newly created entities that promise to become the U.S. version of the financial supermarket.[6] The umbrella scheme rejects the integrated supervisory model and retains a hybrid of both functional and institutional regulation[7] — the hallmark of the balkanized system of financial regulation in the U.S.

At least on the surface, the U.K. and U.S. adopted opposite approaches to the oft-debated questions of whether single-agency integrated supervision is necessary to effective financial regulation and whether central banks must be directly involved in bank supervision. While this Article focuses on the question of the role of central banks in bank supervision, given the trend toward integrated supervision, the question of single-agency supervision will touch upon the analysis of the central bank's role as well.

Part II provides context for the discussion by describing the current status of central banks as supervisors around the world, first examining the role of the new European Central Bank and then surveying the role of the central banks in all Organisation for Co-operation and Development ("OECD") countries.[8] Part III considers the supervisory roles of the Bank of England and the Federal Reserve following the passage of the FSMA and GLBA, respectively. Part IV synthesizes the current debate, both theoretical and empirical, on whether the implementation of monetary policy and bank supervision should be separated. In light of the pros and cons set forth in Part IV, Part V evaluates the current status of the Bank of England and the Federal

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5. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C.).

6. *See infra* Part III.A.

7. For a full discussion of the hybrid model of functional and institutional regulation, see Heidi Mandanis Schooner, *Functional Regulation: The Securitization of Banking Law, in* FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY 189 (Patricia A. McCoy ed., 2002).

8. Comprised of thirty member countries, the OECD is "an international organisation helping governments tackle the economic, social and governance challenges of a globalised economy." OECD, *at* http://www.oecd.org (last visited Jan. 23, 2003).

Reserve. Part VI concludes by offering certain recommendations for reform and making predictions for the future.

II. CENTRAL BANKS AS BANK SUPERVISORS

Central banks have a long history.[9] Therefore, the question of whether a nation's central bank should or should not be tasked with bank supervision is normally complicated by long-standing traditions and relationships. Contrast this with the European Central Bank ("ECB").[10] The establishment of the ECB generated lively discussion regarding the role of central banks as supervisors.[11] Thus, the ECB's supervisory role pro-

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9. For example, the Federal Reserve System was established in 1913 — a mere babe compared with the Bank of England, which was founded in 1694.

10. *See* European Central Bank, *at* http://www.ecb.int (last visited Jan. 23, 2003). For a comprehensive discussion of legal issues relating to the ECB, see CHIARA ZILIOLI & MARTIN SELMAYR, THE LAW OF THE EUROPEAN CENTRAL BANK (2001).

11. *See, e.g.,* Carmine Di Noia & Giorgio Di Giorgio, *Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?,* 2 INT'L FIN. 361 (1999); Dr. Willem F. Duisenberg, The Future of Banking Supervision and the Integration of Financial Markets, Speech Presented to the Euro Group (May 22, 2000), *available at* http://www.ecb.int/key/00/sp000522.htm; Charles M. Kahn & João A. C. Santos, *Allocating Lending of Last Resort and Supervision in the Euro Area,* SSRN ELECTRONIC LIBRARY (Apr. 2002), *at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=310542 (last visited Mar. 31, 2003); Tommaso Padoa-Schioppa, EMU and Banking Supervision, Lecture at the London School of Economics, Financial Markets Group (Feb. 24, 1999), *available at* http://www.ecb.int/key/sp990224.htm.

The ECB also issued the following press release on its position in the debate:

> The recent debate on the reorganisation of the supervisory structures in some euro area countries has led the Governing Council of the ECB to assess the involvement of central banks in prudential supervision.
>
> The Governing Council is firmly convinced that there are valid reasons, also in relation to the effects of the introduction of the euro, arguing in favor of maintaining a strong involvement of central banks in prudential supervision.

Press Release, European Central Bank, The Role of Central Banks in Prudential Supervision (Mar. 22, 2001), *available at* http://www.ecb.int/press/01/pr010322.htm. Of course, this position is not surprising given the fact that the Governing Council's membership is dominated by the governors of member states' central banks.

vides a backdrop for broader consideration of the role of central banks internationally.

The Treaty Establishing the European Community ("EC Treaty")[12] established the ECB as the central bank for the countries that adopted the euro.[13] The European System of Central Banks ("ESCB") is comprised of the ECB and the central banks of member states.[14] The ESCB's primary objective is the maintenance of price stability.[15] The ECB does not act as a prudential supervisor.[16] Rather, the EC Treaty provides that the ESCB shall "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."[17] Consistent with the treaty provisions, the ECB's statute (annexed to the EC Treaty) provides:

> The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system.[18]

Nonetheless, the statute does contemplate a potential, albeit limited, supervisory role for the ECB even in the absence of an amendment to the EC Treaty:

> In accordance with any decision of the Council under Article 105(6) (ex Article 105(6)) of this Treaty, the ECB may perform specific tasks concerning policies relating to the prudential

12. TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Nov. 10, 1997, O.J. (C 340) 3 (1997) [hereinafter EC TREATY].

13. Twelve European Union member states have adopted the euro: Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, The Netherlands, Austria, Portugal, and Finland. Member states not participating in the euro are: Denmark, Sweden, and the U.K.. For information on the U.K.'s position with regard to any future adoption of the euro, see HM Treasury, *The Government's Policy on Economic and Monetary Union (EMU)*, *at* http://www.hm-treasury.gov.uk/documents/the_euro/euro_index_index.cfm (last visited Mar. 10, 2003).

14. EC TREATY art. 106(1) (ex art. 105a).

15. *Id.* art. 105(1).

16. *Id.*

17. *Id.* art. 105(5).

18. PROTOCOL ON THE STATUTE OF THE EUROPEAN SYSTEM OF CENTRAL BANKS AND OF THE EUROPEAN CENTRAL BANK, art. 25.1, Feb. 7, 1992, O.J. (C 191) 73 (1992).

> supervision of credit institutions and other financial institutions with the exception of insurance undertakings.[19]

In euro area Europe, therefore, prudential supervision remains a matter of national responsibility.[20] That responsibility may be held by a national central bank, which, however, no longer conducts monetary policy.

Even in situations in which a central bank is not the prudential supervisor, (e.g., the ECB), a central bank cannot remain divorced entirely from the supervisory process, particularly during a financial crisis. Moreover, even when central banks are not the *primary* supervisor, central banks' supervisory role may vary to a large degree. For example, the central bank may retain the power to conduct back-up examinations[21] or it may not. Moreover, the central bank's role (when it is not the primary supervisor) is likely to be strongly influenced by the general reputation and stature of the central bank and its governors, as much as by its positive legal authority. As Carmine Di Noia and Giorgio Di Giorgio observe:

> In some countries, an agency in charge of banking supervision could be formally separated from the central bank but acting very closely to it. Such an agency could, in reality, turn out to be strongly dependent on the central bank, even more dependent than a banking supervision department located inside the central bank in another country.[22]

Given these qualifications, Figure 1 provides some quantitative data on the supervisory role of central banks in general.[23] Figure 1 illustrates the seat of primary bank supervision in the OECD countries. The term "primary bank supervision"[24] is

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19. *Id.* art. 25.2.

20. Of course, this issue is by no means closed off to debate; many proposals have been made that would alter the current scheme of supervisory responsibility. *See* Jeroen Kremers et al., *Does Europe Need a Euro-wide Supervisor?,* 6 FIN. REGULATOR 50 (2001).

21. The Federal Reserve retains such power. *See infra* Part III.A.

22. Di Noia & Di Giorgio, *supra* note 11, at 364 n.5.

23. Other studies have used slightly different dividing lines. For example, Di Noia and Di Giorgio examined whether the central banks had monopolist control over bank supervision in the then 25 OECD countries. *See id.* at 366 (table 1).

24. In this Article, this concept of "primary" bank supervisor is derived from U.S. law, under which various supervisory and regulatory provisions are

used here to refer to the agency that conducts regular bank examinations. In Figure 1, central banks with such responsibility are noted in bold.

Figure 1 is constructed to identify which central banks are *primary* bank supervisors rather than which central banks have *a role* in bank supervision. Few would debate the need for a central bank to be involved — at some level — in bank supervision. This will remain true as long as: (1) banks remain important to the overall economy; (2) central banks are responsible for the payment system; and (3) central banks are the lend-

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the responsibility of the "appropriate federal banking agency." Federal Banking law defines the term "appropriate Federal banking agency" to mean:

> (1) the Comptroller of the Currency, in the case of any national banking association, any District bank, or any Federal branch or agency of a foreign bank;
>
> (2) the Board of Governors of the Federal Reserve System, in the case of —
>
> (A) any State member insured bank (except a District bank),
>
> (B) any branch or agency of a foreign bank with respect to any provision of the Federal Reserve Act, 12 U.S.C. § 221 *et seq.,* which is made applicable under the International Banking Act of 1978, 12 U.S.C. § 3101 *et seq.*,
>
> (C) any foreign bank which does not operate an insured branch,
>
> (D) any agency or commercial lending company other than a Federal agency,
>
> (E) supervisory or regulatory proceedings arising from the authority given to the Board of Governors under section 7(c)(1) of the International Banking Act of 1978, 12 U.S.C. § 3105 (c)(1), including such proceedings under the Financial Institutions Supervisory Act of 1966, and
>
> (F) any bank holding company and any subsidiary of a bank holding company (other than a bank);
>
> (3) the Federal Deposit Insurance Corporation in the case of a State nonmember insured bank (except a District bank), or a foreign bank having an insured branch; and
>
> (4) the Director of the Office of Thrift Supervision in the case of any savings association or any savings and loan holding company. Under the rule set forth in this subsection, more than one agency may be an appropriate Federal banking agency with respect to any given institution.

12 U.S.C. § 1813(q) (2000).

ers of last resort. The true debate centers on two queries: (1) Should the central bank be *the* or *one of the* primary bank supervisors? (2) If the central bank is not a primary regulator, what then is its appropriate non-primary role? Figure 1 further notes whether the primary bank supervisor is also an integrated supervisor.

Figure 1: OECD Countries: Agency with Primary Bank Supervisory Authority

Country	Primary Bank Supervisory Authority	Notes and References
Australia	Australian Prudential Regulatory Authority	The APRA is responsible for prudential regulation of banks and insurance companies. http://www.apra.gov.au.
Austria	Finanzmarktaufsicht (Austrian Financial Market Authority)	The FMA was established on April 1, 2002 as an integrated financial supervisor. http://www.fma.gv.at
Belgium	Commission Bancaire et Financière (Banking and Finance Commission)	http://www.cbf.be/mov.htm
Canada	Office of the Superintendent of Financial Institutions	http://www.osfi-bsif.gc.ca/eng/default.asp
Czech Republic	**Ceska narodni banka** (Czech National Bank)	http://www.cnb.cz/en/index.php

Denmark	Finanstilsynet (Danish Financial Supervisory Authority)	The FSA is an integrated financial supervisor organized under the Minister for Economic Affairs. http://www.ftnet.dk
Finland	Rahoitustarkastus (Financial Supervision Authority)	The FSA was established in 1993 as an integrated financial supervisor. Furthermore, the FSA "operates in connection with the Bank of Finland but is an independent decision-making body." http://www.rahabof.fi/english/index.asp
France	La Commission Bancaire (The Banking Commission)	While the Banking Commission conducts bank examinations, the Banque de France provides the Commission with some staff and resources. http: //www.banque-france.fr/gb/baque/main.htm

Germany	Bundesanstalt für Finanzdienstleistungsaufsicht ("BAFin") (German Financial Supervisory Authority)	BAFin was established on May 1, 2002 as an integrated financial supervisor. http://www.bafin.de/english/index_e.htm
Greece	???pe?a t?? ????d?? (Bank of Greece)	http://www.bankofgreece.gr/en/
Hungary	Zügyi Szervezetek Állami Felügyelete (Hungarian Financial Supervisory Authority)	The FSA was established in April 2000 as an integrated financial supervisor. http://www.pszaf.hu/english/start.html
Iceland	Fjármálaeftirlitið (Financial Supervisory Authority)	The FME was established in 1998 as an integrated financial supervisor. http://www.fme.is/fme.nsf/pages/index.html

Ireland	**Banc Ceannais na Héireann** (Central Bank of Ireland)	The Bank is an integrated financial supervisor. "The Bank is statutorily responsible for the supervision of most financial institutions in Ireland including banks, building societies and a broad range of non-bank firms, exchanges and collective investment schemes." *See* http://www.centrabank.ie/mainpage.asp
Italy	**Banca d'Italia** (Bank of Italy)	http://www.bancaditalia.it
Japan	Financial Services Agency	The FSA was established in 1998 as an integrated financial supervisor. http://www.fsa.go.jp/indexe.html
Korea	Financial Supervisory Commission	The FSC was established on April 1, 1998 as an integrated financial supervisor. http://www.fsc.go.kr/eng/about/index.htm

Luxembourg	Commission de Surveillance du Secteur Financier ("CSSF")	CSSF is an integrated supervisor (banking and securities). http://www.cssf.lu
Mexico	Comision Nacional Bancaria y de Valores (National Banking and Securities Commission)	CNBV is an integrated supervisor (banking and securities). http://www.cnbv.gob.mx
Netherlands	**De Nederlandsche Bank** (Nederlandsche Bank)	http://www.dnb.nl/english/index.htm
New Zealand	**Reserve Bank of New Zealand**	http://www.rbnz.govt.nz/baning/supervision/index.html
Norway	Kredittilsynet	Kredittilsynet is an integrated financial supervisor. http://www.kredittisynet.no
Poland	Nadzór Bankowy (Commission for Banking Supervision).	It has strong ties to the National Bank of Poland ("NBP"). For example, the Commission's Chairperson is the president of the NBP.) http://www.nbp.pl/en/onbp/index.html (see "banking supervision" for a description of the Commission)
Portugal	**Banco de Portugal** (Bank of Portugal)	http://www.bportugal.pt/default_e.htm

Slovak Republic	**Narodna banka slovenska** (National Bank of Slovakia)	http://www.nbs.sk/INDEXA.HTM
Spain	**Banco de España** (Bank of Spain)	http://www.bde.es/homee.htm
Sweden	Finaansinspektionen (Swedish Financial Supervisory Authority)	Finannsinspektionen is an integrated financial supervisor. http://www.fi.se/english/index.asp
Switzerland	Eidgenössische Bankenkommission (Swiss Federal Banking Commission)	http://www.sfbc.admin.ch/
Turkey	Hazine Müstesarligi (Turkish Treasury)	http://www.treasury.gov.tr/indexe.htm
United Kingdom	Financial Services Authority	The FSA was established on December 1, 2001 as an integrated financial supervisor. http://www.fsa.gov.uk/
United States	**Federal Reserve**, Office of the Comptroller of the Curency ("OCC"), Federal Deposit Insurance Corporation ("FDIC"), State Agencies	http://www.federalreserve.gov/default.htm (Fed); http://www.occ.treas.gov/index.htm (OCC); http://www.fdic.gov/ (FDIC); http://www.csbs.org/links/state_links.asp (state banking agencies)

In one-third of OECD countries, the central banks possess primary responsibility for bank supervision. The percentage can also be stated differently. In France, Poland, and Finland, the supervisory agencies are separate, but still have strong ties to the central bank.[25] If France, Poland, and Finland are included as countries whose central banks are primary bank supervisors, then 43% of OECD countries task their central banks with primary bank supervision.

Figure 1 also displays a significant recent phenomenon. Thirteen of the thirty OECD countries have integrated financial supervisory authorities, almost all of which were rather recently established. Most noteworthy in the context of the role of central banks is that only one of the integrated financial supervisors is a central bank (Central Bank of Ireland). Against this backdrop, Part III compares the supervisory roles of the Bank of England and the Federal Reserve following recent legislative initiatives.

III. THE ROLE OF THE CENTRAL BANK IN BANK SUPERVISION UNDER THE FSMA AND GLBA

Many OECD countries have enacted legislation that alters the regulatory responsibilities of existing financial regulators or creates new agencies. It is particularly interesting to study the recent approaches of the U.S. and U.K. given the very different results achieved in terms of the role to be played by the central bank. This Part describes the roles envisioned for the Federal Reserve and the Bank of England following the passage of the GLBA and FSMA, respectively.

A. The Federal Reserve

Prior to the passage of the GLBA, the Federal Reserve was the primary regulator for state member banks and for bank holding companies.[26] Under the GLBA, the Federal Reserve retains these responsibilities and is also the primary regulator for the new financial holding companies,[27] which are also bank

25. *See supra* Figure 1.

26. Federal Reserve Act of 1913, 12 U.S.C. § 221 (2000).

27. Financial holding companies are the vehicle for expanded activities permitted under the GLBA. *See generally* Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Responses to the Regulatory*

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holding companies. The Federal Reserve's role as primary regulator for state member banks gives it hands-on responsibility for only a small percentage of deposit institutions.[28] Conversely, the Federal Reserve's authority over bank holding companies gives it, at least, indirect access to most banks and certainly the most important ones. Bank holding companies continue to control the vast majority of U.S. bank assets. In 2001, 6,318 bank holding companies operated in the U.S. and controlled 6,420 insured commercial banks.[29] Commercial banks controlled by bank holding companies held 94.2% of all insured commercial bank assets.[30]

Because of the restrictions the GLBA places on the activities of bank subsidiaries,[31] the Federal Reserve retained a meaningful role in supervision as the primary regulator of bank holding companies (including financial holding companies).[32] Nonetheless, Congress demonstrated a clear preference for direct regulation by the functional regulators rather than the Federal Reserve. For example, the GLBA provides that the Federal Reserve may require reports[33] from bank holding companies and their subsidiaries, but that "the Board shall, to the fullest extent possible, accept" reports that the bank holding company or

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Challenges of Modern Financial Markets, 38 TEX. INT'L L.J. 317 (2003) [hereinafter Schooner & Taylor, *U.K. and U.S. Responses*].

28. In 2001, the Federal Reserve Banks examined 534 of the 970 state member banks. State member banks accounted for 12.1% of all insured commercial banks and held 25.9% of all U.S. commercial bank assets. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, EIGHTY-EIGHTH ANNUAL REPORT OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM 143 (2001), *available at* http://www.federalreserve.gov/boarddocs/rptcongress/annual01/ar01.pdf [hereinafter 2001 ANNUAL REPORT OF THE FEDERAL RESERVE].

29. *Id.*

30. *Id.*

31. *See* Schooner & Taylor, *U.K. and U.S. Responses*, *supra* note 27, *at* 325.

32. In the absence of significant restrictions on the activities of bank subsidiaries, banking firms could choose to forego the bank holding company structure and thereby avoid Federal Reserve supervision entirely.

33. Such required report must relate to "(i) [the bank holding company's or subsidiary's] financial condition, systems for monitoring and controlling financial and operating risks, and transactions with depository institution subsidiaries of the bank holding company; and (ii) compliance by the company or subsidiary with applicable provisions of [the GLBA] or any other Federal law that the Federal Reserve has specific jurisdiction to enforce against such company or subsidiary." 12 U.S.C. § 1844(c)(1)(A) (2000).

subsidiary has provided to other state or federal regulators.[34] Moreover, in a case in which the Federal Reserve requests a report from a functionally regulated subsidiary[35] of a bank holding company that is not already required by another federal or state regulator, the Federal Reserve "shall first request that the appropriate regulatory authority or self-regulatory organization obtain such report."[36]

Similarly, the GLBA vests the Federal Reserve with authority to examine bank holding companies and their subsidiaries. Yet the Federal Reserve may examine a functionally regulated subsidiary of a bank holding company only if:

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34. 12 U.S.C. § 1844(c)(1)(B)(i)(I) (2000).

35. A functionally regulated subsidiary is:

> any company —
>
> (A) that is not a bank holding company or a depository institution; and
>
> (B) that is —
>
> (i) a broker or dealer that is registered under the Securities Exchange Act of 1934;
>
> (ii) a registered investment adviser, properly registered by or on behalf of either the Securities and Exchange Commission or any State, with respect to the investment advisory activities of such investment adviser and activities incidental to such investment advisory activities;
>
> (iii) an investment company that is registered under the Investment Company Act of 1940;
>
> (iv) an insurance company, with respect to insurance activities of the insurance company and activities incidental to such insurance activities, that is subject to supervision by a State insurance regulator; or
>
> (v) an entity that is subject to regulation by the Commodities Futures Trading Commission, with respect to the commodities activities of such entity and activities incidental to such commodities activities.

12 U.S.C. § 1844(c)(5) (2000).

36. 12 U.S.C. § 1844(c)(1)(B)(iii)(I) (2000). If the Federal Reserve does not receive such a report and the report is "necessary to assess a material risk to the bank holding company or any of its depository institution subsidiaries" then the Federal Reserve may require the report from the functionally regulated subsidiary. 12 U.S.C. § 1844(c)(1)(B)(iii)(II) (2000).

> (i) the Board has reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution,
>
> (ii) the Board reasonably determines, after reviewing relevant reports, that examination of the subsidiary is necessary to adequately inform the Board of [the systems for monitoring and controlling financial and operational risks], or
>
> (iii) based on reports and other available information, the Board has reasonable cause to believe that a subsidiary is not in compliance with this Act or any other Federal law that the Board has specific jurisdiction to enforce against such subsidiary . . . and the Board cannot make such determination through examination of the affiliated depository institution or bank holding company.[37]

Therefore, following the passage of the GLBA, the Federal Reserve ceased annual examination of subsidiaries conducting securities activities (formerly known as "Section 20 subsidiaries").[38] Even with regard to the Federal Reserve's examination of depository institutions, the GLBA instructs the Federal Reserve to defer "to the fullest extent possible" to the appropriate federal or state banking regulator.[39]

The Federal Reserve has limited authority to set capital standards for bank holding company subsidiaries that are not depository institutions.[40] Furthermore, unless the Federal Reserve possesses specific jurisdiction to do so, the Federal Reserve may not prescribe regulations or impose administrative restrictions on any functionally regulated subsidiary unless:

> (1) the action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty by such subsidiary that poses a material risk to –
>
> > (A) the financial safety, soundness, or stability of an affiliated depository institution; or
> >
> > (B) the domestic or international payment system; and

37. 12 U.S.C. § 1844(c)(2)(B) (2000). The Federal Reserve conducted no special examinations of this kind in 2001. *See* 2001 ANNUAL REPORT OF THE FEDERAL RESERVE, *supra* note 28, at 146.
38. 2001 ANNUAL REPORT OF THE FEDERAL RESERVE, *supra* note 28, at 145.
39. 12 U.S.C. § 1844(c)(2)(D) (2000).
40. 12 U.S.C. § 1844(c)(3) (2000).

> (2) the Board finds that it is not reasonably possible to protect effectively against the material risk at issue through action directed at or against the affiliated depository institution or against depository institutions generally.[41]

Consistent with the framework envisioned by Congress, the Federal Reserve describes its supervisory role with regard to financial holding companies ("FHCs") as distinct from supervision over traditional banking holding companies ("BHCs"):

> The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not viewed as an extension of more traditional bank-like supervision throughout an FHC. The FHC framework [of supervision] is consistent with and incorporates principles that are well established for BHCs.[42]

While the Federal Reserve's role as umbrella supervisor is not intended to duplicate the role of the banking agencies, its regulatory role remains focused on safety and soundness and not on other goals of financial regulation, such as consumer protection. In describing the objectives of financial holding company supervision, the Federal Reserve states:

> The Federal Reserve, as umbrella supervisor, will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with those activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company in order to assess how these risks might affect the safety and soundness of depository institution subsidiaries.[43]

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41. 12 U.S.C. § 1848a (2000).

42. Framework for Financial Holding Company Supervision, Letter from the Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, to the Officer in Charge of Supervision and Appropriate Supervisory Staff at Each Federal Reserve Bank and to Financial Holding Companies (Aug. 15, 2000), *available at* http://www.federalreserve.gov/boarddocs/SRLETTERS/2000/SR0013.htm.

43. *Id.*

B. Bank of England

Pursuant to the Bank of England Act of 1998, responsibility for regulating depository institutions was transferred from the Bank of England ("the Bank") to the Securities and Investments Board (later, the FSA).[44] Under the FSMA, the FSA was established as regulator for banking, securities, and insurance firms. Despite the divorce of the Bank from the formal supervision of banks, there is little doubt that this institution will continue to play an important role in bank supervision.

The Bank has three core purposes,[45] two of which have strong ties to bank supervision. First, the Bank is charged with "maintaining the integrity and value of the currency."[46] Second, the Bank must promote the stability of the financial system.[47] Third, the Bank must promote the effectiveness of the financial system.[48] The second core purpose relates directly to bank supervision and, according to the Bank, translates into three main areas of work:

> 1/ analysing, and promoting initiatives to strengthen, the financial system's capacity to withstand shocks;
>
> 2/ surveillance, that is monitoring developments in the financial system to try to identify potential threats to financial stability at an early stage; and
>
> 3/ reinforcing arrangements for handling financial crises should they occur.[49]

Further recognition of the Bank's role in supervision is found in the Memorandum of Understanding between HM Treasury, the Bank of England, and the FSA ("MoU"), which provides that "[t]he Bank will be responsible for the overall stability of the

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44. Heidi Mandanis Schooner & Michael Taylor, *Convergence and Competition: The Case of Bank Regulation in Britain and the United States*, 20 MICH. J. INT'L L. 595, 646–47 (1999) [hereinafter Schooner & Taylor, *Convergence and Competition*].

45. BANK OF ENGLAND, BANK OF ENGLAND 2002 ANNUAL REPORT 16 (2002), *available at* http://www.bankofengland.co.uk/annualreport/2002report.pdf [hereinafter BANK OF ENGLAND 2002 ANNUAL REPORT].

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

financial system as a whole . . . ."[50] Apart from its specific monetary policy and payments systems responsibilities, the Bank is responsible for the:

> broad overview of the system as a whole. The Bank will be uniquely placed to do this: it will be responsible for monetary stability, and will have high level representation at the institution responsible for financial regulation (through the Deputy Governor (financial stability), who will be a member of the Financial Services Authority Board). Through its involvement in the payments systems it may be the first to spot potential problems. The Bank will be able to advise on the implications for financial stability of developments in the domestic and international markets and payments systems; and it will assess the impact on monetary conditions of events in the financial sector . . . .[51]

Further, the MoU contemplates "official financial operations" by the Bank in exceptional circumstances to prevent systemic breakdown.[52] Finally, the Bank is charged with "the efficiency and effectiveness of the financial sector, with particular regard to international competitiveness."[53] Many of these responsibilities will dovetail with bank supervision. One specific recent example of the Bank's continued involvement in bank regulation is the Bank's representation, along with the FSA, of the U.K. in negotiations regarding the new Basel Capital Accord.[54]

IV. SHOULD CENTRAL BANKS SUPERVISE?

Driven in part by the question of bank supervision in euro-area countries,[55] a growing body of literature addresses whether central banking and bank supervision should be combined.[56]

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50. Memorandum of Understanding between HM Treasury, the Bank of England and the FSA ¶ 2 (Oct. 28, 1997), *available at* http://www.bankofengland.co.uk/legislation/mou.pdf.

51. *Id.* ¶ 2(iii).

52. *Id.* ¶ 2(iv).

53. *Id.* ¶ 2(v).

54. BANK OF ENGLAND 2002 ANNUAL REPORT, *supra* note 45, at 22.

55. *See supra* Part II.

56. *See, e.g.,* Di Noia & Di Giorgio, *supra* note 11; Charles Goodhart & Dirk Schoenmaker, *Should the Functions of Monetary Policy and Banking Supervision Be Separated?,* 47 OXFORD ECON. PAPERS 539 (1995) [hereinafter Goodhart & Schoenmaker, *Monetary Policy and Banking Supervision*]; Charles Goodhart & Dirk Schoenmaker, *Institutional Separation Between Supervisory*

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This Part summarizes both theoretical and empirical arguments for and against the separation of central banking and bank supervision. These arguments are presented in three categories: (1) the combination of macroeconomic and microeconomic goals; (2) the concentration of power; and (3) independence and other institutional considerations.

A. Combination of Macroeconomic and Microeconomic Goals

Reluctance to task central bankers with bank supervision most often focuses on the ways in which the macroeconomic goals (price stability)[57] and microeconomic goals (safety and soundness) can conflict. A central bank may be more willing to lend to banks it supervises and this may conflict with monetary policy goals.[58] Moreover, the central bank might be tempted to manipulate policy instruments, e.g., interest rates, to benefit

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and Monetary Agencies, 51 GIORNALE DEGLI ECONOMISTI E ANNALI DI ECONOMIA 353 (1993) [hereinafter Goodhart & Schoenmaker, *Institutional Separation*]; Joseph G. Haubrich, *Combining Bank Supervision and Monetary Policy*, ECON. COMMENT. SERIES (Nov. 1996), *at* http://www.clev.frb.org/research/com/1196.htm; H. Robert Heller, *Prudential Supervision and Monetary Policy, in* THE EVOLVING ROLE OF CENTRAL BANKS 57 (Patrick Downes & Reza Vaez-Zadeh eds., 1991); EDUARDO LUNDBERG, MONETARY POLICY AND BANKING SUPERVISION FUNCTIONS ON THE CENTRAL BANK (Banco Central Do Brasil, Working Paper Series 2, 2002), *at* http://www.bcb.gov.br/ingles/public/wps/wps02.pdf; Joe Peek et al., *Is Bank Supervision Central to Central Banking?*, 114 Q. J. ECON. 629 (1999); José Tuya & Lorena Zamalloa, *Issues on Placing Banking Supervision in the Central Bank, in* FRAMEWORKS FOR MONETARY STABILITY: POLICY ISSUES AND COUNTRY EXPERIENCES 663 (Tomás J.T. Baliño & Carlo Cottarelli eds., 1994).

57. The term "price stability" is used here as a generalized label for the monetary policy goal of central banks. Of course, the specific goals of individual central banks may vary. The Federal Reserve's statutory mandate with regard to monetary policy is as follows:

> The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.

Federal Reserve Act of 1913, 12 U.S.C. § 225a (2000).

58. The significance of this conflict is questionable given the central bank's ability to off-set the effect of lending to an individual bank through its open market operations. *See* Goodhart & Schoenmaker, *Institutional Separation*, *supra* note 56, at 361.

banks under its supervision.[59] This line of reasoning draws on a regulatory capture premise, i.e., that the central bank will ignore its monetary objectives in favor of furthering the interests of its regulated constituents.[60]

Similar to the conflict-oriented analysis is the preference for a single purpose. The principle is that a central bank performs better when it is focused on a single goal (i.e., price stability) as opposed to two (i.e., price stability and safety and soundness). In support of these arguments, Carmine Di Noia and Giorgio Di Giorgio found that central banks achieve better price stability when they are not required to juggle price stability with sole responsibility for bank supervision.[61]

The conflict of interest arguments may underestimate the trade-offs faced by central banks. As a practical matter, central banks can face multiple, and sometimes conflicting, macroeconomic objectives. For example, the Federal Reserve, by statute, is bound by the goals of "maximum employment, stable prices, and moderate long-term interest rates."[62] It may be true that any conflict created by the combination of macro- and microeco-

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59. As Goodhart and Schoenmaker explain:

> [T]he conflict of interest may arise between the monetary authorities, who wish for higher rates (e.g. to maintain an exchange rate peg, to bear down on inflation, or to reduce the pace of monetary growth), and the regulatory authorities who are frightened about the adverse effects such higher rates may have upon the bad debts, profitability, capital adequacy, and solvency of the banking system. It is in this guise that the conflict has, indeed, from time to time occurred.

Id.

60. For a recent study showing "that the separation of powers in regulation may act as a commitment against the threat of regulatory capture," see Jean-Jacques Laffont & David Martimort, *Separation of Regulators Against Collusive Behavior*, 30 RAND J. ECON. 232 (1999). This provides further support for arguments in favor of regulatory competition. *See infra* Part IV.B.

61. Di Noia and Di Giorgio conclude:

> We find that the inflation rate is considerably higher and more volatile in countries where the central bank acts as a monopolist in banking supervision than in countries where this responsibility is assigned either to another agency or to more than one agency (possibly including the central bank).

Di Noia & Di Giorgio, *supra* note 11, at 361.

62. 12 U.S.C. § 225a (2000).

nomic goals is less troublesome than the conflicts within the macroeconomic goals.[63]

Support for combining central banking with bank supervision focuses on the positive synergies between the macroeconomic and microeconomic goals. This is especially true in countries with bank-centered capital raising markets.[64] Empirical research suggests that confidential supervisory information can assist central banks in achieving monetary goals.[65] Close relationships with banks will assist the central bank in anticipating the direction of the economy and in addressing financial crises. Intimate knowledge of banks will avoid inappropriate access to lender of last resort lending. Bank supervision enables the central bank to protect the payments system from the risk of contagion.

A recent U.S. study found that the Federal Reserve's "monetary policy responsibilities do alter its bank supervisory role . . . . In particular, the stance of monetary policy, as captured by the federal funds rate, affects the supervisory behavior of the FED, but does not affect the behavior of the [FDIC and OCC]."[66]

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63. In 1995, Goodhart and Schoenmaker observed regarding the experience of the Bank of England:

> In any case, the experience of the UK, an example of a country with a politically subservient central bank, suggests that such conflicts of interest between regulatory and monetary objectives are an order of magnitude less important than conflicts between purely monetary objectives and political imperatives.

Goodhart & Schoenmaker, *Monetary Policy and Banking Supervision, supra* note 56, at 546.

64. *See* Peek et al., *supra* note 56, at 651.

65. *See id.* (study on the use of confidential supervisory information by the Federal Reserve). Importantly, this study notes that the Federal Reserve could obtain confidential supervisory information without actually being a bank supervisor. *Id.* at 647. However, the authors conclude that "'hands-on' supervisory experience may be necessary to identify the nuances of changes in bank health that contribute to the effective conduct of monetary policy." *Id.* at 652.

66. Vasso P. Ioannidou, Does Monetary Policy Affect the Central Bank's Role in Bank Supervision?, Tilburg University Center Discussion Paper 2002-54, at 23 (unpublished manuscript, on file with author). Ioannidou found that:

> [W]hen the FED increases the federal funds rate, it becomes less strict with respect to its bank supervisory role. One explanation is that the FED compensates banks for the extra pressure it puts on them when it increases the funds rate, either because it views them

This finding does not necessarily favor the separation or the combination of the two functions. It does, however, highlight the fact that the safety and soundness of banks is linked strongly to the performance of the overall economy. All other things being equal, strength in monetary policy should lead to easier bank supervision.

B. Concentration of Power

Opposition to the combination of monetary and supervisory tasks is sometimes premised on an aversion to concentration of power. Particularly in the U.S., the public remains suspicious of big government; this sentiment prevails in popular press coverage of the Federal Reserve.[67] In addition to the public's suspicions, concentration of power in a single agency can pose particular problems for the regulated. Some of the normal checks against the abuse of regulatory power might be chilled when the regulatory function is combined with other power. For example, a bank might be reluctant to challenge regulatory actions (anything from proposed rulemaking to an enforcement action) for fear that the central bank might retaliate by imposing higher reserves and limiting access to other services.

When the central bank is the sole bank supervisor, the benefits of regulatory competition[68] are also lost. This observation favors separation of the monetary and supervisory functions but also suggests that supervisory functions should be divided among multiple regulatory agencies. In the U.S., three federal government agencies — the Federal Reserve, Office of the

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> as its constituency or because it is concerned about the micro-stability of the financial sector.

Id. The study relied on formal enforcement actions as a measurement of bank supervision.

67. Popular books about the Federal Reserve include: MURRAY N. ROTHBARD, THE CASE AGAINST THE FED (1994); EUSTACE MULLINS, THE SECRETS OF THE FEDERAL RESERVE: THE LONDON CONNECTION (1983); WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY (1987).

68. For a discussion of regulatory competition in the context of financial institutions, see Edward J. Kane, *Competitive Financial Regulation: An International Perspective*, *in* THREATS TO INTERNATIONAL FINANCIAL STABILITY 111 (Richard Portes & Alexander K. Swoboda eds., 1987). *See also* Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1 (1977) (exploring the issue of domestic regulatory competition in detail).

Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC") — and individual state agencies, share supervisory responsibility.

Most observations regarding concentration of power are negative, but for some, particularly developing, countries, such concentration may prove beneficial. In some countries, the stature of the central bank may be a necessary force behind a nascent supervisory regime. Centralized power may be necessary to compel a change in the culture of regulation.

With power comes responsibility. A central bank that performs poorly as a bank supervisor may suffer from lost credibility, which could seriously compromise its effectiveness in implementing monetary policy.[69] On the other hand, a central bank or other supervisor without clear regulatory responsibility can escape blame for poor performance.

C. Independence and Other Institutional Considerations

Recent support for central bank independence is strong and has translated into an international trend.[70] The need for independence in the implementation of monetary policy, however, does not necessarily commute to bank supervision. On the one hand, bank supervisors might be more effective when they are insulated from political pressures.[71] On the other hand, to the extent that bank supervision involves the activities and interests of individuals and firms, bank supervision should be subject to the kinds of checks and balances provided by judicial review and political accountability.[72]

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69. For an interesting discussion on why credibility is so important to central bankers, see ALAN S. BLINDER, CENTRAL BANKING IN THEORY AND PRACTICE 62–66 (1998).

70. *See generally* Michael Taylor, *Central Bank Independence: The Policy Background*, *in* BLACKSTONE'S GUIDE TO THE BANK OF ENGLAND ACT 10 (1998); Geoffrey Miller, *An Interest-group Theory of Central Bank Independence*, 27 J. LEGAL STUD. 433 (1998); BLINDER, *supra* note 69, at 53–76.

71. Lastra advocates for some degree of independence for bank supervisors and contends "that the US Savings and Loan Associations' debacle might have been prevented or at least mitigated had non-political considerations more firmly prevailed in their supervision." ROSA MARIA LASTRA, CENTRAL BANKING AND BANKING REGULATION 55 (1996).

72. In fact, the Federal Reserve does not enjoy the same independence when acting as a bank supervisor as it does when implementing monetary policy. For example, when the Federal Reserve initiates an enforcement action against a bank or bank manager, the Federal Reserve is subject to the

Independence in monetary policy is achieved in several ways. One way is to ensure that the policymaker has freedom in the means for achieving goals proscribed by the legislator. For example, the Federal Reserve is mandated to pursue the goals of "maximum employment, stable prices, and moderate long-term interest rates,"[73] but the decisions of the Federal Open Market Committee on how to achieve those goals are practically irreversible.[74] Another way to achieve independence is through independent funding. For example, the Federal Reserve's operations are funded not through appropriations, but through assessment on the Reserve Banks.[75]

Consideration of the source of funding is important to the question of separation of monetary policy and supervision. When a bank rescue is funded privately, the public's desire for oversight is less than when a bank rescue is funded through the taxpayer. In this regard, Charles Goodhart and Dirk Schoenmaker observe:

> When the government has been providing the funds, either directly to rescue the banks, or indirectly via institutions established to support the banking system, it is likely to wish to have a final oversight in the operation of the regulatory system. He who pays the piper calls the tune. As the rescues are increasingly being financed by the tax-payer, so the responsibility for supervision and regulation of the system — in order to avoid excessive calls on such tax-payers' funding — has been passing more and more from central banks to separate agencies established under the aegis of the authorities.[76]

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same judicial review as the other federal banking agencies. In bringing formal enforcement proceedings such as cease and desist orders, civil money penalties, and removal and prohibition orders, the Federal Reserve is the "appropriate Federal banking agency" ("AFB") for state member banks. The OCC is the AFB for national banks; the FDIC for state nonmember banks; and the Office of Thrift Supervision ("OTS") for savings institutions. 12 U.S.C. § 1813(q) (1996). Judicial review for enforcement actions brought by any of the AFBs is set forth in 12 U.S.C. § 1818(8)(D) (2000).

73. 12 U.S.C. § 225a (2000).

74. *See* BLINDER, *supra* note 69, at 55. Taylor argues that the true source of the Federal Reserve's independence is political. *See* Taylor, *supra* note 70, at 14–15.

75. Schooner & Taylor, *Convergence and Competition*, *supra* note 44, at n.62.

76. Goodhart & Schoenmaker, *Monetary Policy and Banking Supervision, supra* note 56, at 543–44.

While the observations regarding funding of bailouts may justify the separation of macro and micro economic functions, other institutional observations suggest the benefits of a central bank's involvement in supervision. Recently, Charles Goodhart, Dirk Schoenmaker, and Paolo Dasgupta studied the skills of central bank supervisors versus non-central bank supervisors.[77] They found that "central banks employ more economists and fewer lawyers in their supervisory/financial stability wing than non-central bank supervisory agencies."[78] Staffing with relatively more economists would seem to provide a better macroeconomic perspective on supervision.[79]

V. THE FSMA AND GLBA MODELS: ELEGANT ALTERNATIVES OR UNTESTED GUESSES?

The U.K. and the U.S. clearly diverge with regard to the role of the central bank in supervision.[80] The Bank of England, previously the primary supervisor of banks, lost its role entirely. It retains some involvement in bank supervision, but not in a hands-on sense. The Federal Reserve was and remains one of three primary federal bank supervisors.[81] With the passage of the GLBA, the supervisory responsibilities of the Federal Reserve arguably increased and certainly did not diminish. With regard to the question of the central bank's role in supervision, both the British and American approaches could be described as elegant. Britain scores high marks for its direct and consolidated approach to supervision and for its bold move with regard to the Bank of England. Quite simply, the FSA is the bank supervisor and the Bank of England is not. While some may wish to see the MoU[82] as a hedge against a total severing of ties with the central bank, it remains clear that the prudential responsibility rests with the FSA.

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77. Charles Goodhart et al., *The Skill Profile of Central Bankers and Supervisors*, 6 EUR. FIN. REV. 397 (2002).

78. *Id.*

79. *Id.* The authors note that when consumer protection is the regulatory goal, legal skills are more appropriate. *Id.*

80. For a discussion of the reasons for such divergence, see Schooner & Taylor, *U.K. and U.S. Responses*, *supra* note 27.

81. For the purposes of discussion of the U.S. system of regulation, the term "bank" shall be used to refer to commercial banks and not savings associations.

82. *See supra* Part III.B.

In contrast, the GLBA approach may prove exquisite for its opposite tack. The complex division of supervision combined with Federal Reserve umbrella oversight potentially achieves a delicate balance of the pros and cons detailed in Part III. This Part examines whether, given the arguments for and against separation, the American or British system represents a superior solution in the current debate on the role of central banks in bank supervision. This Part will again consider the issues defined in Part IV: (1) combination of macro and microeconomic goals; (2) concentration of power; and (3) independence and other institutional considerations.

A. Combination of Macroeconomic and Microeconomic Goals

In a sense, Britain's approach to bank supervision provides the ultimate answer to the conflict between macro and microeconomic goals. Divorcing the Bank of England from direct supervision preserves a single macroeconomic focus[83] for the Bank and eliminates the conflict incentive. The question remains whether the Bank's continued limited role in supervision provides the Bank with sufficient tools to promote the stability of the financial system.[84] While few would quarrel with the appropriateness of the Bank's continued involvement in safety and soundness issues, the question remains whether, particularly in a crisis, this involvement will give the Bank sufficient competence with regard to individual financial institutions to do its job.

Given the dichotomous approaches, one might conclude that the Federal Reserve's role in supervision would leave it prey to conflicts, yet, at the same time, provide the synergistic benefits of close supervision of individual institutions. The reality is far more complex.

The Federal Reserve lacks the single focus granted to the Bank of England. The Federal Reserve is tasked with both monetary policy and bank supervision, and its role as a bank supervisor is further complicated by the fact that supervisory responsibility in the U.S. is dispersed among several regulators.

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83. Of course, the same cannot be said for the FSA. The FSA as an integrated supervisor is responsible for implementing diverse legal regimes, i.e., safety and soundness versus consumer protection.

84. This is one of the Bank's three core purposes. *See supra* Part III.B.

The Federal Reserve is the primary supervisor for state-chartered member banks, but not for state-chartered non-member or national banks.[85] Of course, any bank that is part of a bank holding company or financial holding company is subject to Federal Reserve supervision, including examinations and reports. Still, the clear expectation is that the Federal Reserve will rely on the work of the FDIC and OCC with regard to the banks they supervise.[86] Under this scenario, the Federal Reserve is responsible for directly supervising 955 of the 8,005 commercial banks.[87] Those institutions hold $1,706,559 million of the $6,504,593 million total assets held by commercial banks. Of the 955 banks the Federal Reserve supervises, only 26 hold assets of $10 billion or more, and the other 929 have assets under $1 billion.

This means that the Federal Reserve is involved in the direct examination of many small banks. These examinations are conducted by the Reserve Banks and thus are physically separated from the policymakers in Washington, D.C. The benefit is that policymakers in Washington are less likely to be influenced by the needs of individual banks, with which the field offices have the direct contact. The downside is that policymakers may lack the intimate knowledge of the banks that the Federal Reserve supervises — keeping in mind that these are, for the most part, small banks.

This brings the focus back to the Federal Reserve's role as umbrella supervisor. The Federal Reserve retains the legal authority to supervise banks. Under certain circumstances, the Federal Reserve can conduct back-up examinations and demand reports of any bank and any non-bank subsidiary of a bank holding company.[88] In addition, the Federal Reserve conducts annual inspections of large bank holding companies. It conducted 1,212 such inspections (1,118 on site; 94 off site) in 2001.[89]

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85. 12 U.S.C. § 1813q (2000). The FDIC is the primary federal regulator for state-chartered, non-member banks and the OCC is the primary federal regulator for national banks. *Id.*

86. *See supra* Part III.

87. These numbers are as of March 31, 2002. *See* FDIC Statistics on Banking, *at* http://www.fdic.gov/bank/statistical/statistics/sectionc.html.

88. *See supra* notes 42–43 and accompanying text.

89. 2001 ANNUAL REPORT OF THE FEDERAL RESERVE, *supra* note 28, at 144.

Unlike the Bank of England, the Federal Reserve bears direct responsibility for the safety and soundness of bank holding companies and financial holding companies,[90] and thus has much greater incentive to exercise its secondary supervisory powers. Perhaps this provides both the incentive and legal access that will result in the Federal Reserve having sufficient intimacy of banks to achieve desired synergies. Balanced against this is Congress' clear intent for the Federal Reserve's role in supervision to be derivative — thereby leaving an unclear picture as to whether the Federal Reserve's role achieves an elegant balance of the evils of conflicts and the benefits of synergies.

Despite Congress' somewhat contradictory "give with one hand and take away with the other" approach to the Federal Reserve's role as umbrella supervisor, it remains clear that the Federal Reserve retains greater formal supervisory authority with regard to prudential matters than does the Bank of England. Still, the practical effect of this difference remains to be seen. The Bank of England had no formal authority for bank supervision until 1979. Before and after that time, the Bank often used an informal style of supervision that stands in contrast to the more formal, legalistic style employed in the U.S.[91] Therefore, while the Bank of England has lost its formal authority to supervise banks, it may continue to exercise a significant level of informal control, drawing its role in supervision a bit closer to the formal role of the Federal Reserve. This is apt to be true in the short term, i.e., when many of the current FSA staff are former Bank of England employees. Over time, as this personnel connection dissipates, there may be less opportunity for informal influence by the Bank.

B. Concentration of Power

While the FSMA concentrates supervisory power in a single agency, it does not consolidate that supervisory power with the monetary authority. This is a consistent international experience. As discussed in Part I, among OECD countries, only Ire-

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90. *See supra* note 43 and accompanying text.

91. *See generally,* Schooner & Taylor, *Convergence and Competition*, *supra* note 44, at 621 (discussing the British style of moral suasion versus the formal style of supervision in the U.S.).

land has an integrated regulator that is also the central bank. This is also consistent with the current approach in euro-area countries. While monetary authority has been consolidated at the ECB, bank supervision has not.[92] It is possible that bank supervision may eventually be consolidated into a central authority in Europe.[93] It seems unlikely, however, that such power will be vested in the European Central Bank given international trends.

The U.S. remains distant from the international trend toward integrated supervision. Banking, securities, and insurance regulators remain separate. Moreover, even within each of these traditional regimes, there are multiple regulators, i.e., multiple bank regulators, multiple securities regulators, and multiple insurance regulators. The GLBA retains the balkanized regulatory regime that has been a distinguishing mark of the U.S. system since the advent of the dual banking system. If there are advantages to this system, they lie in the potential benefits of regulatory competition. The disadvantages lurk in costly overlap and less than clear accountability. Moreover, it is important to highlight the fact that the U.S. has no integrated supervisor. The Federal Reserve's umbrella authority differs from the type of integrated supervision that has captured international attention. Such umbrella authority is prudential and only applies to the safety and soundness of banks, and not, for example, insurance companies. Therefore, the U.S. system does not capture the benefits, if any exist, of an integrated system of financial regulation.

While the GLBA avoids creating what might be seen as excessive concentration of power in an already very powerful Federal Reserve, it also disperses power in a way that allows accountability to be evaded in a crisis. In other words, if the Federal Reserve misreads or misreacts in the next crisis of banking industry, it is quite possible that it could shift the blame to the primary bank regulators and other functional regulators, despite the Federal Reserve's role as umbrella supervisor.[94]

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92. *See supra* Part III.

93. For discussion of the potential alternatives for European financial supervision, see Jeroen Kremers et al., *supra* note 20.

94. Of course, the converse is also true, i.e., functional regulators could attempt to shift blame to the Federal Reserve, claiming that the Federal Reserve failed in its capacity as umbrella supervisor.

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C. Independence and Other Institutional Considerations

Recent U.S. history confirms the responsibility of taxpayers for financial institution failures. The savings and loan crisis of the 1980s cost taxpayers $132.1 billion.[95] The extensive nature of deposit insurance in the U.S. led to an extensive role for the FDIC in bank supervision.[96] This reality is unlikely to change, especially given recent legislative efforts to increase deposit insurance coverage.[97]

With the extensive and necessary involvement of the FDIC in bank supervision in the U.S.,[98] one can question the necessity of the Federal Reserve's involvement (or the OCC's involvement for that matter) in direct bank supervision. If the FDIC is ultimately financially responsible for bank failures, then the FDIC, and not other agencies, seems the most logical situs for bank supervision.[99]

Deposit insurance coverage is not nearly as extensive in Britain[100] and thus may not justify extensive involvement of the insurer in bank supervision. Moreover, the Bank of England's — and other central banks' — ability and willingness to coordinate and fund bank rescues may have diminished.[101] Again, this supports the separation of functions in Britain.

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95. FEDERAL DEPOSIT INSURANCE CORPORATION, 1 HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE 39 (1997).

96. That is not to say that the Federal Reserve has not also been financially involved in bank rescues. For example, the Federal Reserve provided liquidity support to Continental Illinois Bank (1984), Bank of New York (1985), and Bank of England (1991). *See* Goodhart & Schoenmaker, *Institutional Separation, supra* note 56, at 435–37.

97. The House of Representatives recently passed a bill that would increase the already extensive deposit insurance coverage from $100,000 to $130,000. The Federal Deposit Insurance Reform Act of 2002, H.R. 3717, 107th Cong. § 3(a) (2002).

98. The FDIC has the authority to examine all banks holding FDIC-insured deposits and has the authority to bring enforcement actions against all such banks. The FDIC can also, under certain circumstances, provide open bank assistance. *See generally* The Banking Act of 1933, ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.).

99. For further discussion on this point, see Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. REV. 441, 485 (1998).

100. The Financial Services Compensation Scheme compensates for the first £2,000 in deposits and then 90% of the next £33,000 in deposits. *See* FSCS, *Compensation Limits, at* http://www.fscs.org.uk/about_us/compensation_limits/ (last visited March 5, 2003).

101. Goodhart and Schoenmaker conclude:

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Notwithstanding the above, a central bank's interest in systemic failures implicates its involvement, at some level, in bank supervision. This brings the discussion back to the question of whether a central bank's indirect involvement, like that of the Bank of England or the Federal Reserve's umbrella authority, is sufficient in a time of crisis.[102]

Finally, fundamental differences in the style of regulation in the U.S. and the U.K. may also affect the question of separation. Historically, the U.S. has relied on an increasingly formal style of bank regulation, under which specific statutory controls, e.g., capital regulations and prompt corrective action, are the means of supervision. While the U.K.'s system of regulation has also become increasingly formal, it remains less reliant on specific statutory provisions and more on agency discretion.[103] These differences may implicate different skills on the part of the supervisory staff. It may be the case that the U.S. system of bank supervision is implemented effectively by the legal staffs that are typically employed when bank supervision is separate from the central bank.[104] On the other hand, a system that relies on a more informal system of control may require the skills of economists, such as those on the staffs of a central bank.

VI. CONCLUSION

The GLBA might be justified as a complex but elegant solution to the many advantages and disadvantages of combining

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> But central banks *are* tending to retreat from their previous primary role [in bank rescues] for two related reasons. First the banking system is becoming less clearly defined, fuzzier; consequently it is more difficult to persuade the members of the banking club to agree to co-operate in financing rescues. So, the second reason is that the central bank is less able to organize co-operation on a self-regulatory basis. There is more need to turn to the Government both for statutory measures, and for ultimate financial support. This latter means that the regulatory/supervisory function is tending to shift away from central bank control to an independent body more directly under political control.

Goodhart & Schoenmaker, *Institutional Separation, supra* note 56, at 384.

102. *See supra* Part IV.A.

103. For a full discussion of these differences in style, see Schooner & Taylor, *Convergence and Competition*, *supra* note 44, at 647.

104. *See supra* notes 71–72 and accompanying text.

macro- and microeconomic goals.[105] Through its umbrella authority, the Federal Reserve has access to bank confidential information that could improve its macroeconomic performance. Yet, it remains unclear whether Congress' affinity for functional regulation means that the Federal Reserve will be rendered somewhat detached and therefore unable to take advantage of the synergies available when monetary policy and bank supervisory functions are combined.

The Federal Reserve's continued role as primary supervisor of state member banks lacks justification. If the Federal Reserve is to remain one of the primary bank supervisors, it would make more sense for the Federal Reserve to be responsible for examination of the largest banks, for which issues of systemic stability are salient.[106] Alternatively, given the FDIC's extensive involvement in bank supervision, one might question the necessity of any central bank involvement in direct supervision.

In the absence of proven success of integrated supervisors,[107] it is doubtful that the U.S. will adopt an integrated model. One of the reasons is that it appears that a precondition to the integrated model is the separation of the central bank from the integrated supervisor.[108] The stature of the Federal Reserve, while not completely unshakable, is very secure. Therefore, as a practical matter, it is unlikely that the Federal Reserve will lose bank supervisory authority to another agency — unless it wants to.[109]

Of course, the fate of the Bank of England's remaining limited role as bank supervisor is probably less a function of the success or failure of the FSA and more a product of the future of

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105. Of course, the fact that GLBA might be justified on these grounds does not equate to an explanation of the passage of the statute. More likely, the statute was enacted as a result of various special interest group pressures aimed at retaining or increasing their market share.

106. For example, the Federal Reserve's role as direct bank supervisor could be reserved for the five to ten largest institutions. While this author is not advocating this change, it seems to make more sense than the current division of supervisory responsibility.

107. For discussion of the initial success or failure of the single regulator, see *Costs and Benefits of the Single Regulator*, 6 FIN. REGULATOR 6 (2001).

108. *See supra* Part II.

109. It is interesting to note that one of the possible explanations for the Bank of England's loss of bank supervisory authority was its relative ambivalence to that role. *See* Schooner & Taylor, *Convergence and Competition, supra* note 44, at 635, 638.

bank supervision in Europe. In other words, whether or not the integrated model proves successful, the implementation of that model by European countries on a national level may eventually cede to development of a federal regulator. It is even possible that a dual banking system, not unlike that in the U.S., may emerge as a possible scenario in Europe.

PANEL I (PART 2): DISCUSSION TRANSCRIPT

PROFESSOR BAIR: I enjoyed reading both of these papers very much. I think Jerry [Markham]'s paper explicitly and Heidi [Schooner]'s paper implicitly buttress the case for a need for revamping our current system of functional regulation with its multiplicity of regulators.

That certainly has been the conclusion that I've come to after 20 years working in Washington, as Professor Poser pointed out, both on the futures side, the securities side, and then Treasury, with dealing very closely with bank regulators, as well as insurance regulators. I was the lead administration person on the Terrorism Risk Insurance Bill. And something has got to give. The current system is just not compatible, as it could be with financial innovation facilitating the growth of financial supermarkets and the ability of financial institutions to provide the kinds of financial services their customers want, unfettered by artificial lines demarcating whether it's a future or security or bank product or what have you.

I think from a practical level, from the regulator's perspective, I think the current system increasingly produces very resource-straining turf fights. Jerry [Markham] catalogued the battles with the SEC and the CFEC, some of which I was personally involved in over the years. I used to think that regulatory competition was a healthy thing in terms of providing, producing greater efficiencies with regulation. I'm less convinced that there really is that much benefit from regulatory competition, because I think the turf fights are quite resource draining. I think OTC derivatives, swap market is a prime example where the debate really over the years has been dominated by who should be regulated, not whether or how they should be regulated. And we still don't really have a coherent regulatory policy towards OTC derivatives.

The system also currently does not work for multifaceted financial services firms. It's just not conducive. I'm not going to get into the charting wars that Howell [Jackson] and Jerry [Markham] both in their papers and presentations; they have catalogued all the different regulators. There are hundreds of them out there that you have to deal with if you're offering a full product line of financial services.

So there's just got to be a better way to build the mousetrap. I think it's going to be a very long process, unless there's some major, major crisis — you know, Enron tenfold — that would really precipitate a major revamping of the financial services regulatory structure, I think this is going to be a very long, drawn-out process, along the lines of the Glass-Steagall ten-to-fifteen-year process. But, nonetheless, it needs to be done and must be done if we are going to maintain our international competitive position.

Let me just briefly provide a few specific comments on the papers. I would certainly agree with Heidi that any proposals to move us to a more integrated model that would involve taking the supervisory powers away from the Fed is just a non-starter. First of all, they're not going to give it up. Second of all, I'm not sure they should give it up. I think it's very difficult in a clean distinction between being a central bank and being a bank supervisor. If you are a lender to your member institutions you obviously want some ability to provide some financial integrity oversight of those member institutions. More importantly, those institutions sufficiently large to propose systemic risk, I think you need some direct oversight and authority over those institutions. So I would agree that taking supervisory authority away from the Fed and putting them in a new FSA type structure would not work in the United States.

Similarly, putting it all, as Ireland has done, into the central bank, that's a non-starter as well. Again, I don't think the Fed would want that kind of supreme authority. And, two, I think that's just a really bad idea. Though it's not a perfect analog, if you look at the Ministry of Finance in Japan and the problems that that agency had when the Japanese economy hit the skids, they were totally incapable and I think still are, frankly, of showing flexibility and adaptability to deal with new economic changed circumstances. So I think that's a good — and, again, very well highlighted in Jerry's paper — how concentration of too much power in a single regulator can be a very, very bad thing.

Since we love our multiple regulators, let me just throw out a couple of ideas of how perhaps we could move to an integrated model but still have more than one regulator. Heidi and I were talking about this a bit last night. It was an idea we had kicked around at Treasury and I think we're looking very, very long term. But perhaps you could separate rule-making from super-

visory function, so that you could have a single regulator for rule-making authority for the full financial services product line, but supervision would remain with the Fed. If you just overlay it and let OCC and OTS and the Fed and what have you maintain the supervisory authority over their institutions. But that would be one step, and I think that kind of builds on the coordinating council that the previous administration was trying to move us toward. But that might be a way where we could provide greater integration of financial services regulatory policy, but still not have a quite dramatic taking away of authority from a lot of pre-existing regulators.

Another possibility I think is less desirable might be a possibility would be to create a system of financially integrated supervision and regulation, but separated out according to institution size. It would give the Fed, they could be both the regulator and the supervisor for the very largest financial services company. You could maybe create a new agency with or without the FDIC — I'd have to think about that — for the smaller institutions. At least then . . . you wouldn't have one agency and completely in charge of everything. You would have two agencies which presumably would compete. But their responsibilities would be separated on kind of clean "how big is the institution" as opposed to whether you're doing securities or futures or banking or what have you.

An integrated model, though, in addition to Fed resistance, obviously if you have full integration, the question is what do you do with the securities and futures regulators, because presumably you would fold their function into the new integrated regulator. And I can only assume the SEC and the CFTC would be quite unhappy about that. And I think that is another real, very real issue that needs to be thought about. I mean, Gramm-Leach-Bliley, as Heidi [Schooner] outlined in her presentation, theoretically the Fed is the regulator for financial holding companies. But they basically have no authority to go in and oversee a securities firm. They must defer to the SEC on that. Or a futures firm, they must defer to the CFTC. Or a national bank the OCC, or a thrift, the OTS.

I mean, those kinds of balkanized lines were still maintained under Gramm-Leach-Bliley. So I think going to a truly integrated model where you would fold the SEC and CFTC, those types of functions into an integrated regulator would be a quite dramatic thing to happen, perhaps a good thing to happen in

the long term. But I think there would be a lot of political resistance to that.

That brings me to Jerry's paper. Unfortunately, he didn't get to it at the end, but he had some very interesting new paradigms. If we were going to scrap the current functional lines of securities and futures, he had some very interesting ideas for how we might reorganize the categories that we use to define the regulatory regime. And those were centered in large part along the sophistication of the institutions, their size, whether they were going only institution by institution or whether they were dealing with retail cost customers. Similarly for market regulation, whether they were institutional markets or public markets with retail small investor access. I agree with him, I think, if we were going to be designing a grand scheme, either the short term or long term, that those kinds of distinctions may make more sense than the current lines that we use. I would just have a few caveats. I'm not sure I would go quite as far as he would. I think that regardless of what market or what association you're regulating, no matter their size or sophistication — it's not going to surprise him to hear me say this — I think you always need anti-fraud and anti-manipulation authority.

Fraud is fraud, and you never want to be in a position where the institution that you're regulating has committed fraud and you've got to say you can't do anything about it.

I think that they're all — and Arthur Andersen comes to mind when I say this — I think there are certain types of fraud that perhaps can be handled better in a civil capacity through administrative regulatory proceedings and civil proceedings as opposed to the neutron bomb of the criminal proceeding. There are just situations where fraud works — civil courts and administrative regulatory agencies are better equipped to deal with certain types of cases. So I think whatever regime must always retain that civil anti-fraud authority.

Similarly, anti-manipulation. If you have markets that are setting prices that are relied upon by the general populace, even if those markets are dominated by institutions, I think regulators must retain that anti-manipulation authority. And finally, I also think that somebody — and again maybe this long-term needs to be the Fed — some federal financial regulator needs to be in charge of financial integrity oversight over institutions that are sufficiently large to pose systemic risk.

Let me just, in concluding, re-emphasize that I think this is going to be a very, very long-term process. I mean, we dealt with it at Treasury. Howell indicated the difficulties they had with just a very modest proposal of a coordinating council. And unless there's some industry political support for moving this ball forward — it's good policy — we talk about what good policy is, but unless there's some political push for it, it's not going to happen on the Hill.

I think some of the larger financial services firms are now getting into the fray with this and realize that it is in their business interest, in their competitive interest to push this forward, to work with the Treasury Department and others who have an interest in this, to move the ball forward in terms of regulatory restructuring.

I think there's some interim steps that can be taken. And I will say this now. I couldn't say it when I was at the Treasury Department, but now I'm in academia and I have no power to do anything about it. So I will say it and nobody will care anymore. But I do think the OCC and OTS should be merged. And I say that with the utmost respect for the leadership of both agencies. Jerry Hoff and Jim Gilling are top-notch regulators and their staffs are just absolutely the best. Unfortunately, because of bank consolidations, the number of charters is dwindling. Their revenue basis is becoming increasingly reliant on a few large institutions. This is a very dangerous situation for maintaining an autonomous independent regulator. I think by merging the two you would strengthen the agency, strengthen the prestige of the agency, strengthen its ability to deal with the institutions that hold national charters, whether thrift or bank.

I think this is a harder call, but I think the SEC and CFTC should probably be merged. Unlike the OCC and the OTS, which have very similar cultures and missions in terms of safety and soundness, the SEC and the CFTC have quite different cultures and different product lines and markets. . . . I'm old fashioned. I still recognize distinctions between risk management products and those offered for capital formation and investment. Nonetheless, I think there's sufficient overlap, especially with the institutions, the firms that they regulate, that it makes some sense to merge them.

I would say that with the SEC and CFTC the most important thing would be to make sure the CFTC is not simply subsumed in the SEC culture, but maintains its own separate approach

where it is needed, and separate vibrancy in whatever new commission might be created out of the merger and that that commission had individuals who understood derivatives markets and were sensitive to the different type of regulatory regime that currently applies to derivative markets.

I also think we need to have a national insurance charter, frankly. I think it should be optional, obviously. But I think, again for international competitive reasons, it's just going to have to happen. And I think the sixty-four million dollar question will be whether proponents of an optional national insurance charter can present a convincing case that . . . the new federal regulator, will be just as vigilant on consumer protection issues as the states have been.

I think the NAIC [National Association of Insurance Commissioners] is a top-notch agency. I dealt with them a lot when I was dealing with terrorism insurance. I think that is their front line of defense against a national insurance charter, is that it would hamper consumer protections. I'm not sure that is the case. I'm hoping to do some additional research in that area at U. Mass. [University of Massachusetts]. But I think a well constructed federal insurance charter with a good strong consumer protection program is an option that should be out there for a national insurance company, and frankly consumers. It's not clear to me why somebody in Massachusetts should have different consumer protections than somebody in Florida for so many of these products. The options should be out there for submission to a national regime.

And that takes care of my comments.

PROFESSOR POSER: Thank you very much. Ms. Bair.

We have about ten minutes more. I first would like to ask either one of the two first speakers whether they have any comments commenting on the commentary. And then I'll ask whether any members of the audience have any questions.

PROFESSOR SCHOONER: I would just add to what Sheila [Bair] already said. I think what Sheila [Bair]'s comments show in some ways is that significant improvements could be made without doing something as drastic as what the U.K. did with creating the FSA. We've got such a diverse system that moving a few things around could perhaps lead to significant benefits and maybe even cost savings. And we could still, arguably, if anybody believes that they exist, still have benefits of regulatory competition.

I think that in some ways it's possible that beginning to understand the nature of the substance of the regulation and how the substance of our financial institution regulation is evolving might drive that. Eventually we'll figure out that bank regulation is becoming a little bit more like securities markets regulation, and therefore some aspects of bank regulation may belong more appropriately in an SEC type organization; that a lot of what we do with insurance companies is very much like what we do for banks; and that there might be some shifting slowly over time in that way without doing anything drastic, which is politically not feasible.

PROFESSOR POSER: Are there any questions from the audience?

QUESTION FROM AUDIENCE: [Unintelligible]

PROFESSOR MARKHAM: Good question. The futures industry belonged to America until recent years. We dominated in every respect. Today Eurex is the largest commodity trading exchange in the world. I think our two exchanges are now third and fourth — I'm not sure, because of the LIFFE [London International Futures and Options Exchange] merger, how that went. But we're trailing the pack. Some people have attributed it to regulation. I don't, personally. I think they picked up on electronic trading and were able to out-compete us. But by the back door, our regulatory system sought to protect the exchange monopoly. So you had to trade on the exchange over here. The exchange had this capital interest in the memberships, so they couldn't allow anyone to trade electronically, because they'd lose the time and place advantage on the floor and that was the value of their membership. So that regulatory structure I think is what affected and allowed that competition to develop while they're hanging onto their exchange monopoly.

And we saw that happen, and Sheila [Bair], you may know better. I think the CFMA is probably a direct result of that outflow of that business. We tried to deregulate as much as we could to meet that competition.

MS. BAIR: I think it would be interesting, though. The SEC has been generally viewed as more regulatory than the CFTC on that score. I think a merged agency would have been less captive of the exchanges and perhaps more willing to facilitate electronic competition and off-board trading.

Of course, on the securities side we've had off-board trading for years and the exchanges and the OTC markets sit side by

side and they compete. And it does work pretty well. So I think on that score I would agree with you. It wasn't regulation. It was an unwillingness to anticipate and deal with the competitive threats to the exchanges.

QUESTION FROM AUDIENCE: For any of the panelists, do you see any interest in more increased regulation of the over-the-counter derivatives market or over-the-counter swaps market? To the extent they are engaged in by qualified participants, many of these other regulated industries are participating as counterparties in credit support providers.

PROFESSOR MARKHAM: The Feinstein Bill, I've heard, and I haven't had an update on the last few weeks, was trying, I think, to reimpose some regulation in the over-the-counter market.

Will it get anywhere? I don't know. This has been a political circus. Something may spin out of it. I don't know. There's certainly an impetus for it.

Is there something out there that we've got to worry about, something lurking in the bushes? I don't know. Possibly. But we've dealt with these problems over the years. We keep crying that the world's going to end if we don't do something, but as yet it hasn't. Maybe I'm just an optimist, but I don't have that fear of the unknown, I guess.

PROFESSOR SCHOONER: I think I have a little bit of a fear, but I don't think politically in the near term. The genie's somewhat out of the bottle on the swaps market, and to try to put any kind of comprehensive regulatory regime over at this point, I just don't think it's going to happen.

I do think, hopefully, one of the good things to come out of all this corporate governance, new initiatives and heightened sensitivities to the obligations of corporate boards of directors if they start asking more questions of end users who use these instruments: what is your exposure on these positions; why do they have these positions on; what's the leverage; what kind of risk scenarios has the CFO run? I mean, those types of probing questions from audit committees and boards of directors [are] probably the quickest and fastest way that we can put greater discipline into the types of positions and risks that less sophisticated end users may be taking on in those markets.

QUESTION FROM AUDIENCE: [Unintelligible]

PROFESSOR MARKHAM: I don't know, sir. I don't know that. I know there were Congressional hearings where they

brought in the Enron board and looked at the outside directors, but I have no information.

PROFESSOR SCHOONER: I served with Wendy [Graham] and I would have to take exception to that characterization of her position. I'm unaware of any inquiry into her, what she did on the Enron board. The press reports I've read have indicated that she had been the one saying we need go talk to the SEC about this. Apparently, nobody acted on that.

Wendy [Graham] is a free-market economist by training. But she did believe in efficient regulation. And that was certainly my experience working with her. I think people have unfairly characterized her as anti any regulation. I don't think that's the case. I think she was for good cost benefit analysis and efficient regulation, but not no regulation.

PROFESSOR POSER: In Wendy Graham's defense, I'd have to say that none of the other directors did any more than she did.

Any other questions? Okay. I believe lunch is being served downstairs.

KEYNOTE ADDRESS

THE HONORABLE PETER R. FISHER
UNDERSECRETARY FOR DOMESTIC FINANCE
U.S. DEPARTMENT OF THE TREASURY

THE NEED TO REDUCE REGULATORY ARBITRAGE

The case for creating a financial "super regulator" does not rest on the existence of financial supermarkets but, rather, just the opposite.

We are living in a financial bazaar where different types of financial intermediaries offer us competing products and services to meet our needs for borrowing, saving and investment. While individual vendors may offer us a wider or narrower array of choices, because of the diversity of both the forms of intermediation and of the vendors providing these different forms, we need a system of financial regulation that will promote — not hinder — real competition among all of the vendors of financial services.

In these terms I think there is a compelling case for greater coherence in our rule writing process for financial services, perhaps even for a "super regulator." But I draw a sharp distinction between financial *regulation* — rule writing — and financial *supervision*. Our biggest mistake is that we continue to lump these two together. The promise of Gramm-Leach-Bliley will *never* be fulfilled so long as we continue to muddle the distinction between rule writing for financial services, on the one hand, and the supervision of financial intermediaries, on the other.

A single federal rule writer, or rule writing process, would need to respect and nurture the existence of different forms of financial intermediation and, at the same time, encourage competition among both the forms and the firms that provide them.

A single rule writer would need to respect two principles: first, that like products and like services should receive a like regulatory treatment and, second, that distinct products and distinct services should receive distinct regulatory treatment.

The rule writer need only have the wisdom to know the difference.

Supervision — the hands on business of looking over the shoulders of the financial intermediaries — will and should remain divided among a number of different agencies and organizations, focused discretely on individual firms, products, and different policy objectives. We will and should have functional supervision and we will and should also have goal-oriented supervision. Somebody is going to supervise banks and somebody is going supervise insurance companies and somebody is going to try to protect consumers and investors. I see very few, if any, benefits from rolling all of these different purposes and objectives into a "super supervisor."

Having stated by my conclusions let me now explain my logic.

I am skeptical of the view that the future belongs to large conglomerates operating as financial "supermarkets." Large financial firms do have some important advantages, among them greater potential for diversification. Diversification spreads risk and stabilizes earnings. Yet large firms must continuously work to achieve an effective diversification of their exposures and to avoid risk concentrations lurking inside seemingly diversified portfolios of assets.

Advances in information and communication technology offset some of the scale and diversification advantages that large institutions may have. Today, technology permits small firms to outsource many functions and thereby recapture some of the advantages previously associated only with economies of scale.

Thus, I expect that we will have a world in which nimble financial institutions of varying sizes, including both financial supermarkets and more focused financial firms, will compete with one another.

As a society, we have — and want to retain — different, competing forms of financial intermediation, whether based on charter, product, function, or other form. We can call them banking, insurance, or investment activities or products; we can call them credit intermediation, temporal intermediation and resource allocation; or we can call them making payments and pooling risks.

For my purpose today, it does not matter what typology you want to have in mind. We need only observe that we have different forms of financial intermediation and, as a society, we

want there to be a healthy competition among these forms and the firms that provide them.

For our society the objective is clear: we want progressive improvement in the efficiency with which we convert savings into investment. Both collectively and as individual savers and investors, we want the greatest efficiency possible in this process — minimizing the loss of savings, maximizing the investment. Efficiency in this process promotes the growth of our economy.

What process will create a progressive improvement in the efficiency with which savings are converted into investment?

The dynamic process begins with the *in*efficiency of financial markets which, through competition, tend toward efficiency. The economists' assumption about efficient markets is not helpful because it assumes away the important process of squeezing out inefficiencies. When individual financial intermediaries pursue a profit maximizing strategy in a competitive environment, society benefits from the increased efficiency with which savings are converted into investment.

As this process unfolds, as a rough proxy for improvements in the productivity of capital itself, we should expect to see the aggregate profits of financial intermediaries decline as a percentage of our savings and our investment. The profits of individual firms might grow and aggregate profits might grow in nominal terms, but the better outcome for society would be a decline in total financial intermediary profits as a share of total savings.

From the viewpoint of a particular franchise, this isn't always how financial firms, their lobbyists and even their supervisors tend to approach the subject.

The history of regulatory practice too frequently reflects a different assumption: that to ensure the stability of a given *form* of intermediation we should provide individual *firms* with stable and positive earnings, in part, by limiting the competition they face. I think this is misguided.

I take it as given that too much of our financial regulatory process is aimed at limiting rather than expanding effective competition. We have too much, rather than too little, regulatory arbitrage. Rules that expand competition are in the public interest. Rules that limit competition — either directly or by bestowing unique privileges on a narrow set of firms — are not in the public interest because they limit the forces that help us efficiently convert savings into investment.

In financial services this is not principally a function of "agency capture." Individual firms do have incentives to limit competition and there may be some degree of agency capture. But in financial services a problem arises because the chartering regulatory authority has an incentive to promote the "soundness" of its particular form of intermediation by limiting the competition. Each chartering regulatory authority has just a single corner or piece of the total capital structure of financial intermediation and, thus, has an incentive to "protect" the revenue sources of its franchisees in order to assure their "soundness".

We need to clarify the objectives of the rule writing authority, or the rule writing process, to ensure that it promotes rather than hinders competition among forms of intermediation. To do this, the rule-writing process must respect the different forms intermediation: products that are distinctly banking or distinctly insurance should receive distinct treatment, but for products overlapping industries, we need a set of like rules for like products.

This would ensure that rule writing not stand in the way of competition at the frontiers between intermediation forms and firms. Perhaps we should have single, federal financial rule writer to serve this objective. It might also be plausible to maintain separate agencies charged with rule writing, but accountable to these standards through an appellate process. There could also be a rule writing committee, with binding authority, composed of distinct supervisory agencies. Regardless of what mechanism evolves, our objective must be greater coherence in rule writing to promote effective competition.

One thing I am certain of is that we will not put all of federal financial supervision and regulation into a single agency, nor should we. Concentrating so much regulatory and supervisory power in one place is simply not within the bounds of our political tradition. More importantly, financial *supervision* needs to be focused on specific lines of business and sets of risks.

The existence of financial supermarkets and conglomerates does pose a challenge for supervisors. Somebody needs to focus on risks at the holding company level while others need to focus on risks in particular business lines. But it does not follow that we need a single federal financial supervisor.

Financial supervision almost invariably originates with a desire to avoid or mitigate bad outcomes — losses to depositors, to

investors, or to consumers. As such, supervision tends to begin by focusing on the "negative tail" outcomes — making sure that supervised entities avoid the most harmful practices. The more effective way to avoid negative tail outcomes, however, is to focus on improving median and mode performance and to encourage "positive tail" outcomes.

Indeed, the only compelling case that I can see for financial supervision is as a means of more rapidly disseminating best practice among firms whom we wish to see fail less frequently than would otherwise be the case. To redistribute best practices, the supervisor needs to know what best practice is and, therefore, needs to know something quite specific about the business of the firms he or she supervises. In addition, to be effective, supervision needs to be directed at the level of risk-bearing entities and, within financial holding company structures, there are multiple levels of risk-bearing entities.

Pausing just a moment to consider all the different forms of intermediation and businesses that deliver these services — from credit cards to mortgages to mutual funds to annuities — and to the different corporate forms that can provide their services, will give us sufficient insight, I think, to recognize what little sense it would make to roll all of financial supervision into a single agency. We may, at present, have more federal financial supervisors than is optimal. But I am certain that a single federal financial supervisor would not be optimal either.

The distinction I am drawing between rule writing and supervision is not new. Indeed, for almost thirty years we have been stumbling toward recognition that we want a common set of rules for financial intermediaries while, at the same time, we want to maintain discrete supervisors for different types of financial firms.

Starting in the early 1970s, in the wake of the Herstatt crisis, the Basel Committee on Banking Supervision began to write common rules, eventually leading to the more than twenty-year effort to write common capital rules for internationally active banks. Also internationally, in recent years there have been increasingly frequent joint efforts among bank, securities and insurance regulators.

Here in the United States, the President's Working Group on Financial Markets, the FFIEC, and numerous congressionally mandated joint studies over the years all reflect efforts of one kind or another to harmonize regulatory practices. The

Gramm-Leach-Bliley Act's functional regulation provisions and rulemaking process for authorizing new activities of financial holding companies have also represented steps in this direction.

I think we should stop dragging our feet and accept what we have long been seeking in a piecemeal, erratic fashion.

A more coherent, unified rule writing process would properly recognize different modes of intermediation while encouraging competition among them. Retarding this process is not in the public interest and will only serve to decrease the potential efficiency of converting our savings into investment. The supervisory process, however, will and should remain diverse, aimed at each risk-bearing entity within financial firms and at different policy objectives.

If we continue to muddle along, the promise of the Gramm-Leach-Bliley Act to adapt our financial laws to the realities of the 21st century will never be fulfilled.

FINANCIAL MARKET REGULATION AND SUPERVISION: HOW MANY PEAKS FOR THE EURO AREA?

Giorgio Di Giorgio[*]
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I. INTRODUCTION

Financial markets have developed significantly throughout industrialized countries in the last decades of the twentieth century. This path is evident with regard to banking and financial intermediaries, capital markets, and financial instruments. Accordingly, many European nations have either modified their financial systems — regulatory and supervisory — to reflect this development[1] or are currently debating whether to implement such modifications.[2] In Europe, with the start of Phase III of the European Economic and Monetary Union ("EMU"), the responsibility for monetary policy in the euro area has been assigned to the European Central Bank ("ECB"),[3] while banking and financial supervisory tasks have been left to domestic agencies.[4] This development, which reflects "[t]he abandonment of the coincidence between the area of jurisdiction of monetary policy and the area of jurisdiction of banking su-

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1. As is the case most recently with Germany, Austria, Ireland, Portugal and the Netherlands, and earlier in the Scandinavian countries and the United Kingdom.

2. As in the case of Italy and France.

3. Tommaso Padoa-Schioppa, *EMU and Banking Supervision*, 2 INT'L FIN. 295, 297 (1999).

4. *Id.* at 269.

pervision," was a relative novelty in the euro area.[5] This geographical and functional "double separation" between central banking and banking supervision[6], along with the absence of any explicit reference to responsibility for financial stability in the euro area, has cast doubts about the efficacy of the current regulatory arrangements in preventing and managing financial crises.[7] As a consequence, both academic and institutional venues throughout the euro area are now discussing various proposals for financial system regulatory reforms.[8]

Naturally, the first decision lies between choosing either centralized or decentralized financial regulation. National level regulation and supervision are faced with great difficulties within the context of increasing financial markets integration and cross-border mergers among banks, securities firms, and insurance companies. However, the task of fully centralizing regulatory and supervisory activities at the euro level has proven equally challenging, given the current differences in fiscal and commercial codes, and accounting practices across member countries.

This work presents a proposal for the reorganization of regulatory arrangements and supervisory agencies in the EMU. It

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5. Tommaso Padoa-Schioppa, EMU and Banking Supervision, Lecture at the London School of Economics Financial Markets Group (Feb. 24, 1999), *available at* http://www.ecb.int/key/sp990224.htm.

6. Padoa-Schioppa, *supra* note 3, at 297.

7. *Id.* at 305.

8. *See* KAREL LANNOO, CENTRE FOR EUROPEAN POLICY STUDIES ("CEPS"), TASK FORCE REPORT NO. 30: CHALLENGES TO THE STRUCTURAL SUPERVISION IN THE EU 34 (2000); Xavier Vives, *Banking Supervision in the European Monetary Union* (1999), *at* http://www.iue.it/FinConEU/vives.pdf; EUROPEAN COMMISSION, INTERNAL MARKET DIRECTORATE GENERAL, INSTITUTIONAL ARRANGEMENTS FOR THE REGULATION AND SUPERVISION OF THE FINANCIAL SECTOR (2000), *at* http://europa.eu.int/comm/internal_market/en/finances/banks/arrange.pdf [hereinafter INSTITUTIONAL ARRANGEMENTS]; THE COMMITTEE OF WISE MEN, FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS (2001), *available at* http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf. [hereinafter LAMFALUSSY REPORT]; DIRECTORATE FOR FINANCIAL, FISCAL, AND ENTERPRISE AFFAIRS, ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT ("OECD"), CONSOLIDATED SUPERVISION IN THEORY AND IN PRACTICE 8, Doc. No. DAFFE/CMF (2001) [hereinafter OECD 2001]; Stephen A. Lumpkin, *Supervision of Financial Services in the OECD Area,* 81 FIN. MARKET TRENDS 81, 81–139 (Apr. 2002), *available at* http://www.oecd.org/pdf/M00032000/M00032071.pdf [hereinafter OECD 2002].

argues that with a highly integrated single currency, such as exists in the euro financial system, maintaining only domestically-based regulatory schemes and supervisory practices is inappropriate. At the same time, as stressed in the Lamfalussy Report, full centralization appears difficult to achieve in the near future.[9] Hence, this Article suggests a two-level architecture for financial market regulation and supervision inspired by the European System of Central Banks ("ESCB").[10]

This innovative proposal's theoretical underpinnings for euro area financial market regulation reform, may be found within the new literature on the theory of financial intermediation.[11] This literature emphasizes the similarities rather than the differences among banking and other financial intermediaries.[12] The main similarities include the provision of risk management services to customers, and decreasing the participation costs in ever more complex financial markets.[13] Indeed, the traditional lines that divide financial institutions, instruments, and markets into banking, insurance, and securities sectors have become blurred in advanced industrial countries.[14] Technological, geographical, and functional integration has led to despecialization of the intermediaries and the reduction of the "reserved activities" that previously characterized different types of financial operators.[15] The traditional tripartite division of the financial market (i.e., the banking, insurance, and securi-

9. LAMFALUSSY REPORT, *supra* note 8, at 10.

10. The European System of Central Banks ("ESCB") is composed of the European Central Bank ("ECB") and the national central banks ("NCBs") of all fifteen EU member states. The "euro system" is the term used to refer to the ECB and the NCBs that have adopted the euro as currency. The primary objective of the euro system is to maintain price stability. *See* Organization of the European System of Central Banks, *at* http://www.ecb.int/about/escb.htm (last visited Feb. 28, 2003).

11. *See* Franklin Allen & Douglas Gale, *Financial Markets, Intermediaries, and Intertemporal Smoothing,* 105 J. POL. ECON. 523 (1997); Franklin Allen & Anthony M. Santomero, *Theory of Financial Intermediation,* 21 J. BANKING & FIN. 1461 (1997).

12. George S. Oldfield & Anthony M. Santomero, *Risk Management in Financial Institutions,* SLOAN MGMT. REV. 33, 36 (1997); Allen & Santomero, *supra* note 11, at 1462.

13. Allen & Santomero, *supra* note 11, at 1462.

14. *See infra* Part II.

15. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, FINANCIAL MARKET TRENDS NO. 81, SUPERVISION OF FINANCIAL SERVICES IN THE OECD AREA 82 (2002) [hereinafter OECD FINANCIAL SERVICES].

ties sectors) failed to consider that the creation and allocation of savings among sectors cash surpluses and cash deficits, were basically unitary phenomena.

The current stream of literature advocates a unitary view of financial intermediation that requires homogeneous regulation.[16] Contrary to the unitary view, the old "institutional" model for financial market regulation and supervision should be dismissed. In such a traditional regulatory model, supervision is over each single category of financial operator, or over each single segment of the financial market, and all supervisory activities are assigned to a distinct agency.[17] In this institutional model, there are three supervisory authorities acting as watchdogs over: (1) banks; (2) financial intermediaries and mutual funds; and (3) insurance companies and their corresponding markets, respectfully. The authorities control intermediaries and markets through entry selection processes (e.g., authorizations and enrolling procedures in special registers), constant monitoring of business activities (controls, inspections, and sanctions) and decisions about exit from the market (suspensions or removal). "Institutional" regulation facilitates the effective realization of controls. Each intermediary and market has to deal with only one, highly specialized supervisory authority. As a result, this type of regulation avoids duplication of controls and reduces regulation costs. The institutional approach seems to be particularly effective for intermediaries specialized in only one of the three segments of the financial sector. However, when different entities are entitled to perform identical financial intermediation activities, the institutional model may induce distortions in the market. For example, financial supervisors impose different rules upon entities that conduct similar financial services whose only difference is their legal status.[18]

The institutional approach's disadvantages are exacerbated by the trend toward multiple-sector activities and by the progressive de-specialization of intermediaries.[19] In turn, these phenomena are connected to the growing integration of finan-

16. OECD FINANCIAL SERVICES, *supra* note 15, at 98.

17. CHARLES GOODHART ET AL., FINANCIAL REGULATION: WHY, HOW, AND WHERE NOW? 144 (1998).

18. *Id.* at 146–47.

19. *See id.* at 143.

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cial markets and instruments.[20] In a context where the boundaries separating the various institutions are progressively being erased, it is no longer possible to definitively determine whether particular entities are banks, non-banking intermediaries, or insurance companies. Nor is it easy to determine to what degree and extent such entities are engaged in the various financial activities. Therefore, a risk exists that "parallel" systems of intermediaries may form, reflecting only the diversity of the respective control authorities. In this case, the way that institutional controls are established may actually become a destabilizing factor. Moreover, the financial intermediaries might be induced to organize in such a way that their juridical status is contingent upon the different rules that discipline different institutions.

For all these reasons, the recent trend is in favor of a "level playing field" financial regulation model, providing uniform rules for entities that engage in similar activities. Different models of such "transversal" regulation have been adopted recently or are currently under discussion in Europe and elsewhere. The best known solution is the Single Regulator Model, adopted in the United Kingdom ("U.K.") in 1997, as well as in some Nordic European countries (e.g., Sweden and Denmark), and more recently in Austria and Germany.[21]

This Article argues for a more general policy proposal based on the "transversal" model — recently adopted in Australia — which serves to shift the attention away from supervised institutions to the actual "object" of the supervision.[22] It is centered

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20. *See* Richard Dale, *Regulating the New Financial Markets*, *in* RESERVE BANK OF AUSTRALIA, THE FUTURE OF THE FINANCIAL SYSTEM: PROCEEDINGS OF A CONFERENCE (Malcolm Edey ed., 1996), *available at* http://www.rba.gov.au/PublicationsAndResearch/Conferences/1996/Dale.pdf.

21. Michael Taylor & Alex Flemming, *Integrated Financial Supervision: Lessons of Scandinavian Experience,* FIN. & DEV. 42, 42 (1999), *available at* http://www.imf.org/external/pubs/ft/fandd/1999/12taylor.htm. *See also* OECD 2001, *supra* note 8, at 2, 10, 24 n.1.

22. GOODHART ET AL., *supra* note 17, at 149. *See generally* AUSTL. SEC. & INV. COMM'N, ANN. REP. 1999–2000 [hereinafter ASIC ANN. REP.]; OECD 2001, *supra* note 8. In Australia, the Australia Prudential Regulation Authority ("APRA") has identified the coordination of prudential supervision of financial conglomerates as one of its major roles. COUNCIL OF FINANCIAL REGULATORS ANN. REP. 2001, *available at* http://www.apra.gov.au/Policy/loader.cfm?url=/commonspot/security/getfile.cfm&PageID=4835.

on the assignment of different regulatory objectives, or "finalities," to different and independent authorities.[23] These authorities would be competent throughout the financial system, providing homogeneous regulation and supervision regardless of the intermediaries' subjective nature. In the euro area, given the previously mentioned difficulties in choosing a solution between full centralization or decentralization, this Article suggests merging these regulatory models "by objective" into a federal system organized similar to the ESCB. However, it is also argued that the Single Regulator Model may be viewed as a particular case of the regulatory model "by objective," and that the choice between specification or a more complex version depends upon some practical considerations in terms of cost-benefit analysis.

In practice, the proposal advocated in this Article is the establishment of a "European System of Financial Regulators," with either two or three distinct independent authorities along with the ECB at the European level, each being responsible for one or more regulatory objectives. Such a system should characterize these agencies by homogeneous procedures governing their creation, functioning, and funding. In turn, these agencies will push and coordinate the work of their corresponding national authorities within each member country. Under such a regulatory system, at both the European and domestic level, a coordination committee would serve to resolve conflicts and controversies. For this reason, considerable effort would be needed to ensure proper accountability of such independent authorities.

Part II begins with a description of the currently adopted regulatory frameworks for financial markets and intermediaries in the European countries. Part III presents a proposal for a new European architecture for financial market regulation, evaluating the pros and cons of two possible practical and al-

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23. The Council of Financial Regulator's role is to contribute to the efficiency and effectiveness of financial regulation by providing a high level forum for cooperation and collaboration among its members including the Reserve Bank of Australia ("RBA"), which chairs the Council, APRA, and the Australian Securities and Investments Commission ("ASIC"). *See* APRA, *at* http://www.apra.gov.au/Policy/The-Council-of-Financial-Regulators.cfm (last visited Mar. 8, 2003). *See also* Government Online Stategy: The Australian Prudental Regulation Authority's Online Action Plan § 2.4, *at* http://www.apra.gov.au/aboutAPRA/ (last visited Mar. 8, 2003) [hereinafter APRA Online Action Plan].

ternative solutions. Finally, Part IV presents an overview of the issues at hand and provides policy prescriptions for the euro area.

II. FINANCIAL REGULATION AND SUPERVISION IN EUROPE: WHERE DO WE STAND?

Economic regulation aims at correcting market imperfections and unfair distribution of resources, while simultaneously pursuing three general objectives: stability, equitable resource distribution, and efficiency. Regulating and supervising the financial system is particularly important, especially since capital accumulation and the allocation of financial resources are essential for growth and development.[24]

The first objective of financial market regulation is the pursuit of macroeconomic stability.[25] Central banks fulfill this objective through macro-controls over currencies (when applicable), interest rates, payment, and (possibly) settlement systems. They also function as lenders of last resort.

The second objective pertains to micro-stability (i.e., prudential regulation) of the intermediaries.[26] Measures targeting this goal are subdivided into two categories: general rules on the stability of all business enterprises and entrepreneurial activities,[27] and more specific rules due to the special nature of financial intermediation.[28]

The third objective of financial regulation is transparency of the market and of intermediaries, i.e., investor protection.[29]

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24. *See generally* GOODHART ET AL., *supra* note 17; DAVID LLEWELLYN, THE ECONOMIC RATIONALE FOR FINANCIAL REGULATION, FINANCIAL SERVICES AUTHORITY (1999), RICHARD J. HERRING & ANTHONY M. SANTOMERO, WHAT IS OPTIMAL FINANCIAL REGULATION? (Wharton Fin. Inst. Ctr., Working Paper No. 00-34, 1999).

25. GOODHART ET AL., *supra* note 17, at 189.

26. *Id.* at 5–6, 189. *See also* HERRING & SANTOMERO, *supra* note 24, at 4.

27. Such as the legally required amount of capital, borrowing limits and integrity requirements.

28. Such as risk-based capital ratios, limits to portfolio investments and the regulation of off-balance activities, the managing of deposit insurance funds or investor compensation schemes. *See generally* HERRING & SANTOMERO, *supra* note 24, at 17–19.

29. *See* OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION, INTERNATIONAL ORGANIZATION OF SECURITIES REGULATION § 4.2.2, at 8 (1998) ("Transparency may be defined as the degree to which information about trading (both for pre-trade and post-trade information) is made publicly available

This is linked to the more general objective of equitable distribution of available resources and may be viewed as the search for "equity in the distribution of information as a precious good" among market participants.[30] At the macro-level, transparency rules impose equal treatment (e.g., rules regarding takeovers and public offers)[31] and the correct dissemination of information (e.g., rules prohibiting insider trading and manipulation and, more generally, the rules dealing with exchange microstructures and price-discovery mechanisms).[32] At the micro-level, such rules aim at guaranteeing non-discrimination in the relationships among intermediaries and different customers by establishing conduct of business rules.[33]

The fourth objective of financial market regulation, linked with the general objective of efficiency, is the safeguarding and promotion of competition in the financial sector.[34] This type of regulation requires rules for controlling market power and structures, which at the micro level involves mergers and acquisitions regulations, as well as safeguards against cartels and abuses of dominant position. Specific controls over financial intermediaries and markets may be also justified as an attempt to limit destabilizing excesses generated by tough competition in this important sector.

In order to pursue these enumerated objectives, there is neither a unique theoretical model nor a practical approach to the regulation and supervision of financial markets. Literature on these matters identifies significant differences in both the definitions and classifications of regulatory models and techniques.[35] In reality, it is also difficult to observe the adoption of regulatory schemes that are fully consistent with only one theo-

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on a real-time basis."). *See also, e.g.,* CLIVE BRIAULT, THE RATIONALE FOR A SINGLE NATIONAL FINANCIAL SERVICES REGULATOR, FINANCIAL SERVICES AUTHORITY 10 (1999). *See also*, HERRING & SANTOMERO, *supra* note 24, at 9.

30. *See* HERRING & SANTOMERO, *supra* note 24, at 6–8. *See generally* Allen & Gale, *supra* note 11.

31. *See* HERRING & SANTOMERO, *supra* note 24, at 7–8.

32. *See* BRIAULT, *supra* note 29, at 10. *See also* HERRING & SANTOMERO, *supra* note 24, at 9–10.

33. *See* HERRING & SANTOMERO, *supra* note 24, at 7–8.

34. *See*, Lawrence J. White, *International Regulation of Securities Markets: Competition or Harmonization?*, *in* THE INDUSTRIAL ORGANIZATION AND REGULATION OF THE SECURITIES INDUSTRY 208, 219–21 (Andrew W. Lo ed., 1996) [hereinafter White, *International Regulation of Securities Markets*].

35. *See generally* OECD 2002, *supra* note 8.

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retical model. A glance at the European Union's current state of financial market regulatory and supervisory arrangements confirms this, making it evident that multiple regulatory schemes often are in effect.[36]

In each European country, financial markets regulation has been affected by the structure and the evolution of the domestic financial system as well as by the legal system in place.[37] In general, national regulation first focused on banking intermediaries, given their traditional dominant role in continental Europe's financial sector.[38] Most of the recent changes in member countries came about as a result of pressure brought on by EC directives and from increased cross-border financial market integration, which at first stimulated and then followed the 1992 single market program.[39] However, despite EU member countries' implicit commitment to ensuring the adequate regulation and supervision of financial sectors, no European law deals with the problem of how to regulate and supervise financial markets and intermediaries.[40] As a consequence, the EU currently utilizes a combination of different regulatory approaches. Moreover, many member countries also lack a "pure" regulatory model that applies throughout the national financial system.

The Nordic European countries (in particular, Sweden and Denmark), the U.K., Austria, and Germany, have chosen to delegate financial regulation and supervision to a unified

36. *See infra* Figure 1. *See generally id.*

37. *See generally* OECD 2002, *supra* note 8.

38. *See, e.g., id.* at 85.

39. Moreover, in many member countries no "pure" regulatory model is adopted throughout the national financial system. *Id.* at 109–19.

40. *Id.* at 116. Sweden's "single integrated agency" is known as *Finansinspektionen*, which was structurally changed into one agency in September 2000. *Id.* at 116. In Denmark, financial services are supervised by the *Finanstilysynet*, which was created in January 1988. *Id.* at 117. In the U.K., financial services are supervised by the Financial Services Authority, which was created in late 2001, and is subject to the Financial Services and Markets Act of 2000. *Id.* Germany consolidated its various supervisory agencies into the Federal Agency for Financial Market Supervision, or the *Bundesanstalt für Finanzdienstleistungsaufsicht*. *Id.* at 109. In April 2002, Austria also adopted a single regulatory model. *Id.* at 113–14. *See* Carmine Di Noia & Giorgio Di Giorgio, *Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?*, 3 INT'L FIN. 361, 366 (1999).

agency, separated by the central bank.[41] This regulatory approach is a coherent and integral application of the Single Regulator Model, based on just one control authority with responsibility over all markets and intermediaries, regardless of whether in the banking, financial or insurance sector.[42] Such regulatory authority concerns itself with all the objectives of regulation, but in particular with microeconomic stability and investor protection.[43] Recently, Ireland commenced and France announced projects aimed at establishing a new single regulatory agency for financial services in order to consolidate prudential supervision and investor protection across the financial sector.[44]

In most other EU countries, the traditional "institutional" model seems to still be in effect for the insurance sector, in spite of the increasing role of insurance companies as important financial intermediaries. In Belgium, Luxembourg, and Finland, a separate agency is responsible for supervision of banking activities, securities markets, and investment funds and firms, but none exist for insurance. As a matter of fact, contracts involving life insurance and capitalization provide services that are directly tied to investment funds, stock exchange, or other financial indices (i.e., unit-linked or index-linked contracts). All major financial systems should accept the financial regulation of life insurance, since the distinctiveness of most schemes of life insurance, compared to other financial products, has lessened considerably.[45]

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41. *See* OECD 2002, *supra* note 8, at 109, 116–17.

42. *Id.*

43. *Id.* at 118. Ireland's supervisory agency will be known as the Irish Financial Services Regulatory Authority. *Id.*

44. *Id.* at 112–15.

45. In the U.K. system, for instance, long-term life insurance contracts are included under investments (financial instruments) as provided by the Financial Services Act 1986 ("FSA"). The recent establishment of the FSA will further reduce the distinctiveness of insurance companies by applying a common regulation to all financial institutions. Under the U.S. system, variable annuities and variable life insurance contracts whose yield is tied to "separate accounts," fall under the Investment Company Act of 1940, ch. 686, tit. I, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-52 (2000)), which provides the general guidelines relative to investment activities. In the euro area, on the contrary, insurance companies are generally excluded from the set of rules that apply to banks and to other financial intermediaries. In most countries, life insurance policies are not considered financial instruments and

A specialized "institutional" supervisor is also widely in place for the securities market. However, in countries such as Italy and Portugal, security supervisors are only responsible for investor protection, since the central bank assumes the role of safeguarding stability objectives. In this case, the regulatory model by objective applies in part. Another partial application of this model is found in recent Dutch reform.[46] The Netherlands established a single authority for financial market transparency and investor protection, while leaving the supervisory responsibility for microeconomic stability, to either the central bank, for banking and securities, or to a separate agency dedicated to insurance and pension funds.

In many EU countries, banking supervision is one of the functions of the national central bank. However, in some countries, such as Belgium, Luxembourg, Finland, and to an extent France, this task is assigned to a separate agency, or is performed jointly by the National Bank and another agency.[47] In fact, there is a long debate among monetary economists on whether banking supervision and monetary policy responsibilities should be vested in the same institution, namely — the central bank.[48] Although no consensus among the scholars has been reached, there is a general preference towards separating the two functions.[49] The euro area currently overcomes this

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insurance companies are not authorised to perform investment services. Although there is an increasing tendency to recognise the high degree of contiguity between certain insurance products and other financial products, the regulatory differences remain significant and insurance companies are supervised and controlled by a specialized supervisory authority with the exception of Austria and Ireland, where responsibility is given to a government department. In Austria, the government is directly responsible for regulating and supervising the entire financial system, although a recent proposal aims at introducing a separate and dedicated independent agency along the lines of the FSA.

46. *See* OECD 2002, *supra* note 8, at 109–19.

47. VIVES, *supra* note 8. *See also, e.g.,* OECD 2002, *supra* note 8, at 109–19 (reporting on the banking supervisions of EU members including Belgium, Luxembourg, Finland, and France).

48. *See also* RICHARD K. ABRAMS & MICHAEL TAYLOR, ISSUES IN THE UNIFICATION OF FINANCIAL SECTOR SUPERVISION 19–21 (IMF, Working Paper, 2000); Charles Goodhart & Dirk Schoenmaker, *Institutional Separation Between Supervisory and Monetary Agencies*, 51 GIORNALE DEGLI ECONOMISTI E ANNALI DI ECONOMIA 339–58 (1993).

49. Goodhart & Schoenmaker, *supra* note 48, at 337; Di Noia & Di Giorgio, *supra* note 40, at 362–63.

problem, however, because the national central banks, even when acting as financial supervisors, are no longer technically in charge of monetary policy.[50] Figure 1 summarizes the current structure of financial supervision in the EU.

Regionally, the process of financial integration followed quite heterogeneous paths. With regard to the intermediaries, ownership integration has developed through an increasing number of mergers and acquisitions and the establishment of new alliances directed to diversify the business, either geographically or functionally. Even though the process is still characterized by a dominant share of domestic deals, cross-border operations have recently become more important and are likely to develop further in the near future.[51] Currently, traditional banking's prominent role in continental Europe is being challenged by advances in information and delivery technology, and by the entry of new and aggressive financial industry players.[52] While information and delivery technology advances have the effect of lowering barriers to entry in banking and finance, the appearance of aggressive new financial players contributes to the erosion of the traditional banks' monopoly, and comparative advantages in information gathering, monitoring, delivery capacity and processing.[53] In fact, European financial market liberalization also started a deep process of business restructuring across the entire financial sector. The search for economies of scale led to a reduced number of banks, insurance, and financial firms which in turn lead to a considerable increase in market concentration. For these reasons, financial conglomerates gradually become more important, tending to act more and more on an international basis — both at a European and global level.

Considerable integration has taken place between the banking, insurance, and securities markets.[54] In most EU countries, banks and insurance companies are among the most important issuers of stocks and other securities traded in both organized

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50. *See* Padoa-Schioppa, *supra* note 3, at 297.

51. Alberto Cybo-Ottone et al., *Recent Development in the Structure of Securities Markets*, *in* BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 223, 234, 238 (R. Litan & A. Santomero eds., 2000).

52. Padoa-Schioppa, *supra* note 3, at 299.

53. *Id. See also* LANNOO, *supra* note 8, at 5.

54. Goodhart & Schoenmaker, *supra* note 48, at 336.

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exchanges and over-the-counter. Financial products and instruments have also experienced a certain degree of integration, sometimes changing their original economic function.[55] In general, financial products have become increasingly complex, calling for new and enhanced skills in regulatory and supervisory activities. Furthermore, the EMU increased the level of substitutability between national government and corporate bonds because differences in interest rates across member countries vanished. The euro is also impacting the demand side of the stock exchanges' business by making them quasi-perfect substitutes. For example, even though the most important exchange in Europe, the London Stock Exchange, belongs to a non-euro country, a sufficient number of regulatory and fiscal differences between EMU countries still exist.[56]

The adoption of the single currency will speed up a naturally ongoing process of market integration towards financial conglomeration in Europe.[57] Supervising organizations are not necessarily a minor challenge for regulators. If it is true that risk diversification might be within reach, the possibility of excessive risk concentration also exists, especially when a domestic-based regulator looses control over the many internationally linked activities of the supervised entities.[58] Risks at group level do not always coincide with the sum of individual risks. Moreover, larger balances may allow for more creative accounting.

There is no point in having a common monetary policy and aiming at an integrated financial system in the euro area while keeping different financial regulations and supervising rules in each member country. As a matter of fact, these national insti-

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55. ALESSANDRO PRATI & GARRY J. SCHINASI, FINANCIAL STABILITY IN EUROPEAN ECONOMIC AND MONETARY UNION 59–66 (Princeton Studies in Int'l Fin., No. 86, 1999). *Cf.* LAWRENCE J. WHITE, TECHNOLOGICAL CHANGE, FINANCIAL INNOVATION, AND FINANCIAL REGULATION: THE CHALLENGES FOR PUBLIC POLICY 31–33 (Wharton Fin. Inst. Ctr., Working Paper No. 97-33, 1997), *at* http://fic.wharton.upenn.edu/fic/papers/p9733.htm [hereinafter WHITE, TECHNOLOGICAL CHANGE] (noting the change of financial products and instruments in the U.S.).

56. *See generally* Roberta Karmel, *The Case for a European Securities Commission,* 38 COLUM. J. TRANSNAT'L L. 9, 33, 42 (1999).

57. *See generally* VIVES, *supra* note 8, at 6–8, 20.

58. Franco Bruni & Christian de Boissieu, *Lending of Last Resort and Systemic Stability in the Eurozone,* SUERF Studies 41 (2000).

tutional differences serve as barriers to further financial integration and may very well prove to be an impeding factor toward a smooth transition to the EU's single monetary policy.[59] In the field of financial regulation, the principle of minimum harmonization and mutual recognition, which originally was thought to be able to naturally induce a convergence of regulatory behavior and more uniform rules over time, did not work. Moreover, there is a concrete risk that competition in this area will not even generate the more efficient outcome. On one side, an incentive exists to promote less demanding domestic financial regulations and supervision in order to let each country become more attractive on their own for running financial business.[60] On the other side, it is not clear who will pay the costs of potential insolvency following excessive risk taking behavior and financial misconduct in a member country.[61] Finally, with increasing international banking activities and a European real-time gross settlement system in place (e.g., the Trans-European Automated Real-time Gross Settlement Transfer System ("TARGET")),[62] the argument that domestic regulators and supervisors have better knowledge and can exercise more efficient control is becoming less persuasive.[63]

Another important point is that no clear tool of responsibility for countering and/or managing the risk of financial instability and crisis has been established in Europe.[64] The EC Treaty is silent on this topic.[65] It is not even evident that the ECB will perform the role of lender of last resort,[66] which would be desirable because the ECB functionally acts as a central bank. In fact, only in the case of a wide-spread liquidity crisis affecting the whole euro area, would the ECB likely assume such a role.[67]

59. VIVES, *supra* note 8, at 19.

60. *Id.* at 5.

61. *See infra* notes 75–77.

62. TARGET is the payment system of the ESCB. *See* VIVES, *supra* note 8, at 9.

63. *See* Prati & Schinasi, *supra* note 55, at 44.

64. *See* Bruni & de Boissieu, *supra* note 58, at 41, 43, 45.

65. *See* TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Nov. 10, 1997, O.J. (C 340) 3 (1997) art. 105; Di Noia & Di Giorio, *supra* note 40, at 363 n.4; VIVES, *supra* note 8, at 9, 21.

66. *See* Bruni & de Boissieu, *supra* note 58, at 41.

67. *See* VIVES *supra* note 8, at 18 (discussing the ECBs possible involvement).

But it is unclear what would follow a liquidity crisis located in a single member country, or a general solvency crisis.[68]

For these reasons, the EMU needs a higher degree of coordination in the field of financial regulation and prudential supervision. Both regulation and supervision require further harmonization as financial market integration evolves.[69] Such harmonization attempts are currently observable among mergers and acquisitions of stock exchanges.[70] Moreover, Internet development fosters distribution channels for financial services that will render the physical location of the financial firms irrelevant, and will pose additional regulatory problems. In addition, there continues to be a trend towards increasing cross-border mergers among intermediaries, groups, and conglomerates, as well as the dual and cross-border offerings and listings of securities.[71] However, harmonization does not necessarily mean complete centralization. If it is too late to continue with different national regulators and supervisors, it is probably too early for having one or more central regulator(s) and supervisor(s) for the entire euro area. Indeed, not only is the euro area too large, but too many different rules still exist[72] and fiscal

68. Suppose we face a situation in which a single financial institution located in a member country is in trouble. What kind of intervention, if any, is currently allowed? One of the typical forms of public intervention seems lost, and probably the most natural, that of central bank last resort loans. *See* GOODHART ET AL., *supra* note 17, at 353; Xavier Freixas et al., *Lender of Last Resort: A Review of the Literature,* 7 FIN. STABILITY REV. 151, 154–57 (1999), *available at,* http://www.bankofengland.co.uk/fsr/fsr07art6.pdf. The ECB will not intervene in favor of a single institution, especially if its financial links are mostly domestic, because it could always assign some of the responsibility for the crisis to the domestic financial regulator-supervisor. The domestic central bank can not intervene by providing funds without an explicit authorization by the ECB. In this case, it will have to convince the latter that the institution is facing a liquidity and not a solvency crisis, according to the old Bagehot's doctrine, and/or that the risk of potential spread and contagion of the crisis is high. This requires time and resources. The other two traditional instruments, bail out through a safety net provided by the banking system or through the government budget will ultimately shift the burden on the shoulders of domestic taxpayers.

69. Padoa-Schioppa, *supra* note 3, at 300. *See* Dale, *supra* note 20. *But cf.* WHITE, TECHNOLOGICAL CHANGE, *supra* note 55, at 28.

70. *See* Cybo-Ottone et al., *supra* note 51, at 239.

71. *Id.* at 238.

72. For example, rules for commercial codes, company laws, failure procedures, corporate governance, etc.

policies have yet to be harmonized. In addition, national enforcement might still be desirable in most cases. Thus, the only feasible solution is the federal approach to financial regulation and supervision, which could be organized with a structure similar to the one established for monetary policy with the ESCB. The next section examines the regulatory model best suited for the entire euro area, and suggests two feasible institutional architectures to implement such a plan.

III. REGULATION "BY OBJECTIVE" IN THE EURO AREA

The selection of a feasible regulatory model for the entire euro area presents formidable challenges. To begin, the old "institutional" model could be considered a good candidate, but only in a context with rigidly separated financial segments, and where no global players are at stake. But this scenario does not apply to the euro area where a high degree of integration in financial markets and intermediaries as well as multifunctional groups and conglomerates are rapidly growing.[73] Discounting the institutional model, the choice is narrowed down to one of the transversal models — the "by objective"[74] approach and the Single Regulator Model[75]

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73. *See generally* LANNOO, *supra* note 8.

74. LLEWELLYN, *supra* note 24, at 8, 9.

75. A third "transversal" model is the termed "functional supervision," or supervision "by activity." Although never fully applied in practice, this approach assumes the economic functions performed in the financial system, but does not postulate that existing institutions must necessarily continue to exist as such, in terms of both their structure and role. The financial system is considered to perform some basic functions, including: provision of clearing and settlement services; resource pooling; portfolio diversification; provisioning of ways of transferring economic resources through time, across borders, and among industries; risk management services; price information discovery; and reduction of informational asymmetries. These "functions" or activities, undertaken by financial markets and intermediaries, are considered to be more stable than the institutions currently performing them. Robert Merton & Zvi Bodie, *A Conceptual Framework for Analyzing the Financial Environment*, *in* THE GLOBAL FINANCIAL SYSTEM: A FUNCTIONAL PERSPECTIVE 3, 12–16 (Dwight B. Crane et al. eds., 1995).

In the "functional supervisory" model, each of these activities should be regulated by a given authority independently of the operator who offers it. Hence, also this approach has the important advantage that it calls for the same rules to be applied to intermediaries who perform the same activities. Moreover, it fosters economies of specialization within the supervisory authorities and might represent a rather attractive solution for the regulation of inte-

The single regulator solution aims at reaching a more efficient organization of supervisory activities, including a reduction in the costs of regulating itself.[76] The advantages of this approach lie in the economies of scale that it produces — fixed costs, logistical expenses, the administrative personnel costs, and executive management compensation costs are all considerably reduced.[77] Moreover, this regulatory scheme calls for a unified view which is particularly useful and effective with respect to multifunctional groups and conglomerates. By the same token, the costs of supervision charged to those regulated and/or to taxpayers decrease, and there is less room for "regulatory arbitrage."[78] In addition, it is considered useful to have just one agency accountable to the market and to legislative oversight.[79] However, the validity of this model strongly depends on its internal organization: if the numerous areas of competence and specialization are not well-structured and coordinated, the decision-making process risks slowing down. James Q. Wilson in his seminal work on bureaucracy noted that what counts is a clear definition of an agency's "mission."[80] Moreover, the presence of a sole regulator might foment and accelerate collusive relations between the regulator and the regulated (i.e., "regulatory capture.")[81] Finally, this model might exacerbate problems of self-contradiction in the event that the authority should find itself forced to pursue conflicting supervisory objectives.[82] However, an internal organization divided "by objectives" might partially surmount this problem,

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grated, advanced financial markets. However, it has numerous drawbacks. In particular, this model envisions an overlapping of bodies controlling the same subject: there is the risk of an excessive division of powers and responsibilities among the regulatory agencies. A further disadvantage of the functional approach is that finally what is subject to failure is not the activity performed, but the institution. In case of serious problems of stability, it would be essential to guarantee protection and oversight with regard to the institutions rather than to individual operations.

76. *See* BRIAULT, *supra* note 29, at 18–23.

77. *Id.* at 18–20.

78. *Id.* at 19.

79. *See id.* at 18.

80. *See* JAMES Q. WILSON, BUREAUCRACY 101, 109-110 (1989). *See also* ABRAMS & TAYLOR, *supra* note 48, at 6.

81. *See* WILSON, *supra* note 80, at 83–84; ABRAMS & TAYLOR, *supra* note 48, at 16.

82. *See* ABRAMS & TAYLOR, *supra* note 48, at 17.

although the fact that executive management is one of the subject-matter objectives may lead to the creation of a prevalent "single objective" as far as the decision-making process is concerned.[83]

The possible conflict of interest, or trade-off, in pursuing different objectives is of particular interest when they are assigned to the same agency.[84] Under this type of regime, the Single Regulator Model is affected by the possible incompatibility among different supervisory objectives.[85] In the credit sector, for instance, there exists a clear trade-off between competition and stability, at least in the short run. The need to safeguard stability in moments of economic and financial tension led to the use of instruments designed to limit competition, such as institutional barriers to market entry, or to the introduction of legal limits to certain activities.[86] In countries where banks are still dominant national players in the financial sector, but not efficient enough to compete cross-border (e.g., Spain, Italy, Germany), the objective of competition is more easily sacrificed than stability.[87] The consequence is a "stable" environment in terms of the number and identity of intermediaries. But this stability may also be obtained by altering the free play of competition with measures that prevent exit of inefficient actors from the market.

Potential conflict may also develop between the objectives of stability and transparency (investor protection). Again, with regard to the banking sector, scarce transparency in fund gathering activities, for example in the issuance of securities, might allow the application of interest rates at below-market rates. Such behavior could be considered functional to the strengthening of banking's stability, but it would inevitably result in direct injury to investors. The most immediate response to this important problem might be to attribute to different authorities seperate supervision objectives by adopting the regulatory model "by objectives" as the benchmark for advanced financial systems.

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83. *See id.*
84. *See id.*
85. *See id.*
86. *Id.*
87. *See* Padoa-Schioppa, *supra* note 3, at 298.

The supervisory model "by objectives," or by finalities, postulates that all intermediaries and markets be subject to the control of more than one authority — each single authority then remains responsible for each regulation objective regardless of the legal form and functions, or activities that the intermediaries perform.[88] According to this scheme, the first authority watches over prudential regulation and micro-stability of both markets and all intermediaries, regardless of whether in banking, finance, or insurance. Such an agency should supervise the stability of the entire financial market and of individual financial intermediaries by licensing authorizations, controlling professional registers, performing inspections, issuing sanctions, and managing crises. Authorities operating under this model should cooperate with the second authority — the Central Bank — which is responsible for monetary policy and macro-stability, including supervising security settlement and payment systems, clearing houses, and in monitoring the use of financial instruments in wholesale markets.

The third authority under this model is responsible for transparency and investor protection. It should supervise disclosure requirements, the behavior of intermediaries, and the orderly conduct of trading in all financial intermediation activities that banking, securities, and life insurance intermediaries perform.[89] Moreover, such an authority should be assigned powers of regulating misleading advertising by financial intermediaries. Finally, it should also control macro-transparency in financial markets, including the discipline of insider trading, takeovers, and public offers.

A fourth authority should guarantee fair competition, and should guard against abuses of dominant positions and limit dangerous concentrations in banking, security, and insurance sectors. A diagram of this "four-peak" model for financial regulation is provided in Figure 1.

Australia recently chose this form of solution, and it appears particularly effective in a highly-integrated market context, as well as in the presence of multifunctional operators, conglomerates, and groups operating in a variety of different business sec-

88. *See* GOODHART ET AL., *supra* note 17, at 156–57. *See also* OECD 2002, *supra* note 8, at 99-101.

89. Including discipline and control in the area of transparency in contracts.

tors. The "four-peak" model's most attractive feature is that it provides uniform regulation for different entities engaged in similar activities. At the same time, this model does not require excessive proliferation of control units.

Australia's Financial Sector Reform Act of 1999 harmonized financial rules and supervision assignments at the Commonwealth level.[90] The Australian Securities and Investments Commission ("ASIC") protects investors, superannuates, depositors, and insurance policy holders.[91] This agency regulates and enforces laws that promote fairness and proper behavior within the financial markets and exchanges as well as among financial firms and advisors.[92] The ASIC cooperates with three other primary regulatory bodies at the Commonwealth level. For example, the Australian Prudential Regulation Authority ("APRA"), established in 1998, is responsible for ensuring that financial institutions will honor their commitments.[93] The APRA currently safeguards the soundness of deposit-taking institutions, insurance companies, and other financial firms after having inherited the powers and duties previously held by the Australian Central Bank and the Insurance and Superannuation Commission.[94] Monetary policy and systemic stability are assigned to the Reserve Bank of Australia, which is the third institutional member represented in the Council of Financial Regulators, the official site that fosters coordination efforts and resolves conflicts.[95] Finally, the fourth agency, the Australian Competition and Consumer Commission, is charged with antitrust powers and responsibilities.[96]

It is too early to evaluate the success of Australia's recent reforms. ASIC's 1999–2000 Annual Report indicates noticeable improvements in the speed of completing both corporate and

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90. Financial Sector Reform Act, 1999 (Austl.) (repealed).

91. For more information on the Australian Securities and Investments Commission ("ASIC"), see website at www.asic.gov.au/asic/asic.nsf (last visited Mar. 1, 2003).

92. *Id.*

93. *See also* APRA Online Action Plan, *supra* note 23.

94. *Id.*

95. *See generally* Reserve Bank of Australia, *at* www.rba.gov.au/AboutTheRBA.htm (last visited Mar. 2, 2003).

96. *See generally* Australian Competition and Consumer Commission ("ACCC"), *at* www.accc.gov.au/about.htm (last visited Mar. 2, 2003).

market investigations and in the registration of prospectuses.[97] In addition, stemming from Australia's financial reform, the largest number ever of unqualified people were banned from giving investment advice, and 84% of the 461 court cases challenging the ban were upheld.[98] Results from an ASIC benchmarking survey also indicate improved public perception of the effectiveness in regulating financial reporting, corporate disclosure, market integrity and law enforcement.[99]

In 2001, however, HIH Insurance Ltd. ("HIH"), the second largest insurance company in Australia, collapsed.[100] Mounting criticisms of this insolvency brought the new prudential authority, APRA, under pressure.[101] Nevertheless, many of the problems leading to HIH's failure had originated during the previous regulatory scheme. In fact, the APRA publicly recognized the weakness in the previous insurance sector regulation, under the Insurance Act of 1973, and launched a thorough reform, which will be implemented in the near future.[102] Regardless, the Australian Government criticized APRA for its untimely intervention and appointed a Royal Commission to examine case and assess responsibility.[103]

Compared to the "institutional" or the Single Regulator Model, a regulatory framework organized "by objectives" obvi-

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97. *See generally* ASIC ANN. REP., *supra* note 22.

98. *Id.*

99. *Id.*

100. Charles E. Boyle, *Australian Insurer HIH Seeks Bankruptcy Protection as Losses Mount*, INS. J., Apr. 9, 2001, *at* www.insurancejournal.com/magazines/west/2001/04/09/features/17957.htm; David Kehl, E-Brief: HIH Insurance Group Collapse, Parliament of Australia, Department of the Parliamentary Library, *at* http://www.aph.gov.au/library/INTGUIDE/econ/hih_insurance.htm (last visited Feb. 11, 2003).

101. Paul Cleary, *APRA's shortcomings spelt out,* AUSTL. FIN. REV., Sept. 6, 2001, at 6.

102. *Id.* *See also* Insurance Act, 1973 (Austl.), *available at* http://scaleplus.law.gov.au (last visited Mar. 2, 2003); Press Release, No. 02-56, APRA: Both the regulator and the industry have learnt from HIH (Nov. 29, 2002), *available at*.http://www.apra.gov.au/internetapps/Print_Media_Page.

103. Press Conference, Transcript of the Prime Minister, The Hon. John Howard, MP Joint Press Conference with Minister Joe Hockey (Parliament House, Canberra, May 21, 2001), *available at* www.pm.gov.au/news/interviews/2001/interview1060.htm; HIH Royal Commision, Proposed Terms of Reference, June 18, 2001, *available at* www.pm.gov.au/news/media_releases/2001/media_release1100.htm.

ously produces a certain degree of multiple controls.[104] Such regulations may also lead to a lack of other controls, since specific assignment of responsibilities with respect to the objectives of regulation are not necessarily univocal and all-inclusive in practice.[105] Since each intermediary is subject to the control of more than one authority, this regulatory model might also prove more costly.[106] For example, the intermediaries might in fact be required to produce several reports relating to their supervision, which may often contain identical or similar information. The intermediaries may also have to justify the same action to a whole set of authorities contemporaneously, though each for different reasons. *Vice versa*, a deficit of controls might occur whenever the exact areas of responsibilities are not clearly identifiable. Finally, in order to be effective and to avoid the conflicts of interest, a regulatory model organized "by objectives" needs a coordination committee consisting of all the different authorities as well as the central bank.[107]

In practice, however, the difference between the Single Regulator Model and the one "by objectives" is not as relevant. Actually, since it is often the case that antitrust responsibilities in the financial sector are assigned to a dedicated agency, and since the central bank remains in charge of macroeconomic stability, the Single Regulator Model acts as a "three-peak" regulatory model "by objective," in which the two objectives of microeconomic stability — prudential supervision and investor protection — are assigned to a unique agency.[108] In this light, the choice between one of the two alternatives has to be made pragmatically — by comparing the likely costs deriving from conflicts of interest among agencies simultaneously pursuing the targets of microeconomic stability and investor protection,

104. *See* Consolidated Supervision in Theory & Practice, Directorate for Financial, Fiscal, & Enterprise Affairs, Committee on Financial Markets 4 (Mar. 7, 2001) [hereinafter Consolidated Supervision]; GOODHART ET AL., *supra* note 17, at 156–57; LLEWELLYN, *supra* note 24, at 49.

105. *See* BRIAULT, *supra* note 29, at 11.

106. *See, e.g.*, *id.* at 6.

107. *See, e.g.,* LANNOO, *supra* note 8, at 34.

108. *See* Consolidated Supervision *supra* note 104, at 8.

with those costs of establishing one additional agency and its attendant bureaucracy.[109]

A. Financial Regulatory Proposal for the Euro Area

This Article advocates that a modification of the current regulatory structure in the euro area's financial sector would solve some problematic issues regarding financial stability and address the need for greater coordinated transparency and investor protection rules. Of course, structuring and creating such an integrated system of rules and institutions in the EU is far from easy; such a change will require time, resources, political support, and widespread collaborative attitude. Nevertheless, it is hoped that this Article will at least constructively contribute to the current discussion.

As already stressed, whether financial regulation in the euro area should be fully centralized at the European level, or improved through more adept harmonization at the regional level is a difficult question to answer. Many arguments support the view of centralizing and unifying financial regulation in the euro area.[110] However, the feasibility and opportunity of a European centralized solution is diminished by the observation that the euro area might be too large to be controlled by one or two central agencies. Many different rules are still in place with respect to commercial codes, company laws, corporate governance schemes, failure procedures and so on. EU directives, when they actually exist, do only establish a common floor. Different fiscal policies are still in place even with a single currency and a common monetary policy. Furthermore, the EU's taxation of both financial services and other items still lacks homogeneity. In any case, some form of national enforcement is probably still needed.

Hence, the EU should establish a European System of Financial Regulators ("ESFR"), structured similarly to the ESCB and

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109. *See generally* Christian Hawkesby, *The Institutional Structure of Financial Supervision: A Cost-Benefit Approach,* 2 J. INT'L BANKING REG. 36 (2000).

110. *See, e.g.,* WHITE, TECHNOLOGICAL CHANGE, *supra* note 55. In particular, an integrated supervision on markets and intermediaries would be valuable in a scenario dominated by conglomerates and characterized by the expansion of electronic communication networks, market manipulation and trades on the net.

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organized according to the "by objective" model of regulation, which includes the single regulator solution as a particular case. A European Central Authority ("ECA"), separated from the ECB, should be at the system's center for each objective of regulation. In a first stage (lasting for, perhaps, three years), these authorities would be able to harmonize and coordinate financial regulation in member countries, design common principles and guidelines for prudential supervision, and set out appropriate disclosure instruments and requirements. The EU members should sponsor the institutional changes at the domestic level necessary for these institutions to merge and reorganize the supervisory and regulatory powers within the financial sector of each member country. At the end of this process, each country should have only one national agency responsible for each objective of financial market regulation. Each national agency will then participate according to the area's general strategies and principles of financial regulation, becoming a member of the ESFR. These agencies will then implement the rules and the supervisory duties agreed upon at the euro level within their respective country.

The "four-peak" reform model calls for the establishment of two new European agencies — one responsible for microeconomic stability ("European Financial Supervision Authority") and the other responsible for oversight of financial intermediaries regarding transparency in the market, investor protection, and disclosure requirements ("European Authority for Market Transparency"). These two central agencies should then coordinate among the different domestic agencies in each member country. Apart from this vertical form of coordination, cooperation should be engaged horizontally, at both the EU and national levels. The coordination and resolution of eventual controversies could be provided by special commissions for the supervision of the financial system established at the European Commission and national treasuries.[111] These commissions would serve as the breeding ground for proposals and consultations concerning financial market regulation.

Under this regulatory proposal, no member of the ESFR should have antitrust power so as to avoid the trade-off between

111. E. GERALD CORRIGAN, FINANCIAL MARKET STRUCTURE: A LONGER VIEW, ANNUAL REPORT FEDERAL RESERVE BANK OF NEW YORK (1987).

competition, and stability, and transparency. Moreover, since agencies responsible for supervising market competition currently exist at both European and national levels, it would be wise to establish an additional independent central agency — the EU Antitrust General Direction. This agency would then coordinate and promote domestic antitrust agencies. In each member state, the national antitrust agency would be able to safeguard competition in all economic sectors. The proposed "four-peak" model for financial regulation in the EU is schematically presented in Figure 2.

Admittedly, this Article's proposed regulatory structure is indeed ambitious, requiring a substantial amount of coordination among the different authorities. An additional and delicate challenge is that of the accountability of these new and existing independent agencies, a topic that while deserving of separate investigation, lies beyond the scope of this Article. Another important obstacle would be the institutional and political resistance by current national agencies, who would not passively accept the abolishment or weakening of their regulatory powers. For such reasons, the alternative solution of merging financial supervision authority and market transparency agencies into a single regulator may provide a practical solution. A single regulator under this model would diminish the costs of bureaucracy and regulation, and make coordination efforts easier.[112] At the same time, possible conflicts of interest in pursuing investor protection and microeconomic stability, although present, are certainly less relevant than the conflicts of interest between stability and efficiency.[113] In a "three-peak" model, the single European Central Authority for financial market regulation would cooperate with the ECB for the purpose of macroeconomic stability.[114] The ECA would also organize and coordinate the work of various domestic agencies, which in different countries could be either specialized "by objective"[115] or could be re-

112. *See generally* Julian R. Franks et al., *The Direct Compliance Costs of Financial Regulation*, 21 J. BANKING & FIN. 1547 (1997).

113. *See id.* at 1563–64.

114. *See* OECD 2001, *supra* note 8, at 5; OECD 2002, *supra* note 8, at 16, ¶ 50.

115. *See* OECD 2002, *supra* note 8, at 15, ¶ 46, fig. 6.

sponsible for both market transparency and stability as the Financial Services Authority is in the U.K.[116]

In fact, a good example of international cooperation and coordination efforts can presently be found within banking supervision of the Basle Committee, which works on a wide range of topics, employing no formal by-laws, but which maintains a very strong leadership.[117] Furthermore, many institutional arrangements for the regulation and supervision of the financial sector at the EU level already exist. The most important are the Banking Advisory Committee and the Insurance Committee,[118] both possessing comitological powers.[119]

In contrast, securities supervision did not succeed in establishing a similar long record of international rule-making or an EU securities committee capable of comitological powers.[120] The European supervisory system would gain both in consistency and effectiveness if all stability-oriented rules, all transparency-oriented rules, and all competition-oriented rules, for all types of financial institutions and markets were either issued or better coordinated by distinct independent agencies at the euro level. Only recently the Financial Services Action Plan mapped out a first set of improvements to the EU legislative framework for securities markets.[121] Meanwhile the *Committee of Wise Men on the Regulation of European Securities Markets* released a final report indicating a four-step approach to making im-

116. *See* Financial Services Authority, *at* http://www.fsa.gov.uk (last visited Feb. 24, 2003).

117. *See, e.g.,* INSTITUTIONAL ARRANGEMENTS, *supra* note 8, at 17–20.

118. *Id.* at 6–7, 23.

119. Comitology refers to the delegation of implementing powers by the Council to the Commission for the execution of EU legislation — representatives of member states, acting through committees called "Comitology Committees," assist the Commission's execution of its conferred implementing powers. *See* LAMFALUSSY REPORT, *supra* note 8, at 24.

120. *See generally* White, *International Regulation*, *supra* note 34, at 207; John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation,* 50 BUS. LAW. 447 (1994). *See also, e.g.,* KAREL LANNOO, EU SECURITIES MARKET REGULATION: ADAPTING TO THE NEEDS OF A SINGLE CAPITAL MARKET — REPORT OF A CEPS TASK FORCE 34–35 (2001).

121. Financial Services: Implementing the Framework for Financial Markets: Action Plan, COM(1999)232 final (Nov. 1999).

provements in the EU regulation of securities markets that was approved by the European Parliament in February 2002.[122]

IV. CONCLUSION

This Article argues that financial market regulation should be redesigned and harmonized in the euro area according to a regulatory model "by objectives" or "finalities." This calls for assigning all supervisory powers and regulatory responsibilities in financial markets and intermediaries to a limited number of distinct and independent agencies, regardless of their titles as insurance companies, banks, or investment firms. These agencies should be in charge, respectively, of microeconomic stability, investor protection, and competition safeguards in the financial sector. They should cooperate with the central bank for the purpose of guaranteeing macroeconomic stability and financial soundness.

Two new European financial regulation agencies should be established in the euro area, each formally separated by the ECB. These agencies should be responsible for the comprehensive coordination of both legislation and execution of regulation in financial markets: the first ECA should be responsible for the microeconomic stability of all intermediaries; the second for transparency and disclosure requirements; guaranteeing competition in financial and non-financial markets is already safeguarded by having the Antitrust General Direction of the European Commission, as well as the national agencies. It would be wise to transform the "EU Antitrust General Direction" into a central and independent European agency. The latter and the two newly created central agencies would be at the center of three European Systems of Financial Regulators, each one structured similarly and working in connection to the ESCB

122. LAMFALUSSY REPORT, *supra* note 8 (Adopting a broad framework principles: implementation of these principles through a new EU Securities Committee; implementation of Community law by Member States within the framework of strengthened cooperation and networking between national regulators; establishing a European Committee of Securities Regulators; and urging stronger work by the EU Commission to ensure open and fair competition in the European financial markets.) *See also* Financial Markets: Commission Welcomes Parliament's Agreement on Lamfalussy Proposals for Reform, Feb. 5, 2002, *available at* http://europa.eu.int/comm/internal_market/en/finances/general/02-195.htm.

thereby requiring active participation of national agencies in member countries. This setup is essential for maintenance of regulation and supervision at both the European and national levels in this proposed federal regulatory system. If this "four-peak" regulatory model "by objective" leads to an excess of bureaucracy and poses serious coordination problems in the euro area, as well as in each member country, a more practical solution would call for merging the authorities responsible for microeconomic stability and for investor protection into a single agency, following the U.K.'s FSA example. The conflict of interest ensuing in these two objectives is surely less significant than that between stability and efficiency.

Many difficulties are obvious in this proposal. Even in case of a consensus on the final architecture for financial market regulation, it is difficult to design and follow a feasible political and institutional plan to build it. Changes in the Maastricht Treaty are needed in order to establish new agencies.[123] These can be proposed only at the next intergovernmental conference and not before 2004. Changes in the national legislation of each EU member country are also needed, and providing a satisfactory degree of accountability for the new agencies will be a difficult task. Moreover, there most likely will be strong political and institutional opposition to such reforms. To be sure, full financial market integration will require a much higher degree of political integration in Europe.

The authors maintain that there is an observable movement towards a financial regulatory scheme similar to the proposed "four-peak" architecture. With regards to macrostability and competition, there is already an incomplete federal system in place. For investor protection and business conduct, the new committees established in the wake of the Lamfalussy Report have started to coordinate and guide the national securities regulators.[124] The present challenge deals with prudential supervision and microstability of all financial intermediaries. Given the consolidated experience of the Basle Committee on Banking Supervision and the recent experiment of the ESCB and the forum of European Securities Commissions ("CESR"), it

123. MAASTRICHT TREATY: TREATY ON EUROPEAN UNION, Feb. 7, 1992, O.J. (C 191) 1 (1992), 31 I.L.M. 253.

124. *See generally* LAMFALUSSY REPORT, *supra* note 9. *See also European Securities Regulation: Trojan Horses*, ECONOMIST, Feb. 15, 2003, at 67–80.

seems plausible to believe that a new framework for European financial market regulation and supervision will emerge based on EU-level harmonized (secondary) regulation as well as national supervision.

TABLES AND GRAPHS

Figure 1: Current Assignment of Responsibilities for Supervision in Banking, Securities, and Insurance Markets in the EU†

Country	**Banking**	**Securities**	**Insurance**
Austria	U	U	U
Belgium	BS	BS	I
Denmark	U	U	U
Finland	BS	BS	I
France*	CB,B	B,S	I
Germany	U	U	U
Greece	CB	S	G
Ireland	CB,U	CB,U	CB,U
Italy	CB**	CB, S	I
Luxembourg	BS	BS	I
Netherlands	CB,S	CB,S	I,S
Portugal	CB	S	I
Spain	CB	S	G
Sweden	U	U	U
United Kingdom	U	U	U

Key to Figure 1:

CB: Central Bank
BS: Banking and Securities Supervisor
B: Banking Supervisor
S: Securities Supervisor
I: Insurance Supervisor
G: Government Department
U: Single Financial Supervisor

† *Sources*: ECB, MONTHLY BULLETIN (Apr. 2000), *available at* http://www.ecb.int/pub/pdf/mb200004en.pdf; KAREL LANNOO, CENTRE FOR EUROPEAN POLICY STUDIES, CHALLENGES TO THE STRUCTURAL SUPERVISION IN THE EU 34 (2000).

* Project announced to introduce a single financial supervisor.

** In Italy the Central bank is also the authority responsible for antitrust in the banking sector.

Figure 2: A Four-peak Regulatory Model by "Objectives" for the Financial Sector

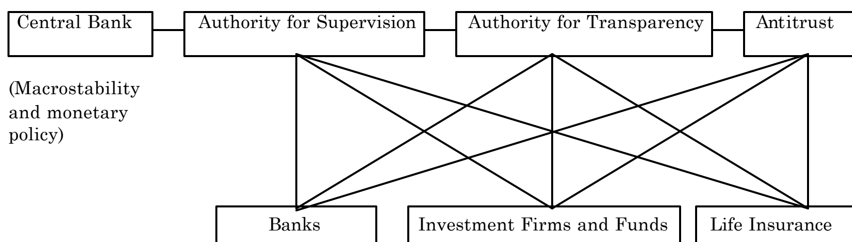
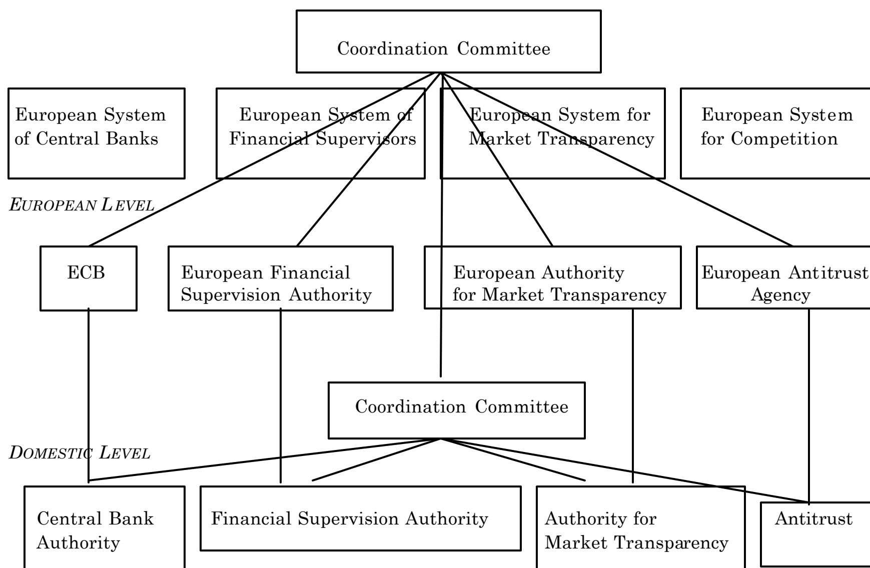


Figure 3: The European System of Financial Regulation



RECONCILING FEDERAL AND STATE INTERESTS IN SECURITIES REGULATION IN THE UNITED STATES AND EUROPE

Roberta S. Karmel[*]

I. INTRODUCTION

Securities law in the United States ("U.S.") is found primarily in the federal securities laws as administered by the Securities and Exchange Commission ("SEC") and interpreted by the federal courts. The federal securities laws were preceded by state securities laws administered by state securities commissions and stock exchange self-regulatory law. Although some key aspects of state securities regulation have been preempted by federal statutes, other aspects remain intact. Litigation in the state courts, by private parties or public prosecutors, sometimes creates securities law. Furthermore, corporation law is primarily state law, even though it is sometimes overridden by the federal securities laws. Self-regulatory organizations ("SROs") continue to adopt and administer securities market law under the SEC's oversight, as well as to administer securities arbitration facilities. In addition to competing with the federal and state courts and with state and SRO agencies as lawmakers, the SEC also competes with other federal financial regulators, in particular with the Commodities Futures Trading Commission, the Federal Reserve Board and the Department of the Treasury, with regard to the parameters of its jurisdiction to regulate securities products and the securities industry. In times of market stress, when investors are dis-

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gruntled, some of the fault lines in the competition among securities regulators and lawmakers become more apparent.

Europe is struggling with similar problems in reconciling federal and state law and regulation concerning the capital markets and public companies. Although a series of securities laws, directives, and the adoption of a single European currency have helped to integrate European capital markets, they remain fragmented to a large extent. European Union ("EU") directives are not self-operating and must be translated into national legislation in every EU member state, a slow and cumbersome process. An ambitious Financial Services Action Plan adopted in May 1999 will require the amendment of some directives and the adoption of new directives by 2005. Although the EU does not have a federal securities commission, two new European Securities Committees have been established to facilitate the realization of the Financial Services Action Plan. The European Court of Justice also creates securities law at the federal level. Although securities law and corporation law remain primarily national, much new securities law is derived from EU directives. Every EU member state now has a government securities commission, but the United Kingdom ("U.K.") has consolidated regulation via the Financial Services Authority ("FSA") and other countries are considering this model. In some countries in Europe there continues to be self-regulation by SROs, but as a general matter SRO regulation has been transferred to government securities commissions.

Some scholars believe that competition among financial regulators is beneficial and results in an optimum level of regulatory intrusion upon private business interests. Proponents of this theory frequently are apologists for deregulation. This author is considerably more skeptical of regulatory competition because it frequently undermines the rule of law. Nevertheless, some competition between federal and state regulators is deeply rooted in constitutional federalism. In both the U.S. and the EU the burden is on the proponents of federal regulation to justify its necessity. This Article will attempt to describe the division between federal and state securities regulation in the U.S. and the EU, suggest that the causes of regulatory competition are historical and political, and explore whether there are principled justifications for allocating regulatory responsibilities among federal, state and SRO interests. In addition, this Arti-

cle will inquire as to how competing regulatory interests should be reconciled.

In general, as the securities markets in the U.S. became more national and securities firms matured, federal securities laws came to trump state laws. Similarly, in Europe, a determination to integrate the capital markets of EU member states led to the need for securities regulation at the EU level. Yet, local or state interests, as well as political beliefs have countered this trend toward centralizing securities law. This tension is very well illustrated in the area of takeover law.

Part II of this Article will outline the framework and historical development of securities law in the U. S., and the long term trend toward federal preemption. Part III will outline the framework and historical development of securities law in the EU. Part IV of this Article will discuss the tension between federal and state interests in takeover law in both the U.S. and Europe, as an example of an effort to reconcile competing regulatory goals. The Article will then discuss, in Part V, the views of the proponents of regulatory competition and the author's reservations about these theories. It will suggest that the fundamental purpose of securities regulation, which is the promotion of investor confidence, should be the guiding principle in allocating regulatory responsibilities between federal, state and SRO lawmakers, and administrators.

II. THE DEVELOPMENT OF FEDERALISM IN U.S. SECURITIES REGULATION

A. Constitutionality of Blue-Sky Laws and SRO Regulation

State corporation law, stock exchange listing requirements and market rules, and state securities regulation (or "blue-sky" laws) preceded federal securities regulation. This tripartite regulatory system was recognized when the first federal securities law, the Securities Act of 1933 ("Securities Act")[1] was passed and when the Securities Exchange Act of 1934 ("Exchange Act")[2] was adopted the following year creating the SEC. The federal-state-SRO system of securities regulation involved conflicting philosophies and considerable overlap and duplica-

1. 15 U.S.C. §§ 77a–77aa (2000).
2. 15 U.S.C. §§ 78a–78mm (2000).

tion. As a general matter, the federal laws covering the flotation of public offerings were based on a full disclosure philosophy, whereas much of the state system was merit based, allowing a blue-sky commissioner to judge whether an issuer's capital structure was fair, just and equitable.

There was not a well articulated allocation of obligations and priorities, and it was not clear that Congress "had any systematic understanding of what the relations of state and federal securities regulations should be, how regulatory responsibilities should be allocated, or how federal disclosure regulation and state merit regulation should be accommodated to each other."[3] SRO regulation, by contrast, set forth merit-based listing and offering standards for public companies,[4] just and equitable principles of conduct for member firms and associated persons,[5] and regulated trading markets and access fees for using those markets.[6] The SEC's authority with respect to altering stock exchange listing standards is unclear,[7] but since 1975 its oversight authority with respect to other SRO rules is fairly well established.[8] On the other hand, SROs are not considered gov-

3. Mark A. Sargent, *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785, 793 (1986).

4. *See* A.B.A., *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW. 1489, 1510–14 (2002) [hereinafter ABA, *Market Structure Report*]. *See also* Rule 2710 (Corporate Financing Rule — Underwriting Terms and Arrangements), N.A.S.D. Sec. Dealers Manual (CCH), at 4501–16 (Mar. 2001) [hereinafter N.A.S.D. Manual].

5. *See* Business Conduct Rules 2100 (General Standards), 2300 (Transactions with Customers), 2400 (Commissions, Mark-Ups and Charges), N.A.S.D. Manual, at 4111–41, 4261–81.

6. Until 1975 the New York Stock Exchange enforced a fixed minimum commission schedule on its member firms. Although fixed commissions were abolished in 1975, *see* Rule 19b-3, 17 C.F.R. § 240.19b-3 (2002), SROs continue to levy other fees, for example, with respect to trading data, subject to SEC oversight, *see* U.S. SECURITIES AND EXCHANGE COMM'N, REPORT OF THE ADVISORY COMM. ON MARKET INFO. (2001), *at* www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm. The NASD continues to have a ban against granting a selling concession or discount in a fixed price offering to a non-broker-dealer. *See* Conduct Rule 2740 (Selling Concessions, Discounts and Other Allowances), N.A.S.D. Manual, at 4534. The NYSE and Nasdaq have numerous market conduct rules.

7. *See* ABA, *Market Structure Report*, *supra* note 4, at 1516–20.

8. *See* Securities Exchange Act of 1934 §§ 6(a), 15(a), 15 U.S.C. §§ 78f(a), 78o(a) (2000). When the Exchange Act was passed in 1934 the SEC had oversight only of stock exchanges, *see* Securities Exchange Act of 1934 § 12, 48 Stat. 881, 892, and broker dealers, *see id.* § 15, 48 Stat. at 895–96. The NASD

ernment agencies, although they exercise delegated governmental authority.[9]

Federal preemption of state law under the Supremacy Clause is not a politically popular mode of legislation. Nevertheless, Congress has frequently preempted state law, particularly in the area of financial regulation. Preemption may be express, implied, or by reason of conflict. Preemption is express when there is an explicit statutory command that state law be displaced.[10] A clear example of express preemption in financial regulation is in the Employee Retirement Income Security Act of 1974 ("ERISA"), which states that the provisions of that act "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan. . . ."[11] Pre-

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was organized after a 1938 amendment adding section 15A of the Exchange Act. Over-the-Counter Market Act, ch. 677, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o-1 (2000)). In 1964, the SEC was given jurisdiction over persons associated with broker-dealers and non-listed issuers. *See* Act of Aug. 20, 1964, 78 Stat. 565 (codified as amended at 15 U.S.C. § 78o(b) (2000)). In 1975, the SEC gained further oversight over exchanges and other market participants. *See* Act of June 4, 1975, 89 Stat. 97 (codified as amended at 15 U.S.C. §§ 78f, q-1s(b)(c) (2000)).

9. "Mere approval" of a private regulation by a government agency does not necessarily constitute state action. Cremin v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 957 F. Supp. 1460, 1466–68 (N.D. Ill. 1997). Whether state action exists depends upon whether there is a sufficient "nexus" between the State and the action that is being challenged. Lugar v. Edmondson Oil Co., 457 U.S. 922, 1004–05 (1982). Courts have rather consistently held that SROs are *not* state actors for purposes of the Due Process Clause of the Fifth Amendment. *See, e.g.,* Desiderio v. Nat'l Assoc. of Sec. Dealers, Inc., 191 F.3d 198, 206–07 (2d Cir. 1999); Bernstein v. Lind-Waldock & Co., 738 F.2d 179 (7th Cir. 1984); United States v. Solomon, 509 F.2d 863, 868 (2d Cir. 1975); Martens v. Smith Barney, Inc., 190 F.R.D. 134, 137–38 (S.D.N.Y. 1999). *But see* Intercontinental Indus., Inc. v. Amer. Stock Exch., 452 F.2d 935 (5th Cir. 1971) (holding that the American Stock Exchange is a governmental agency, due to its "intimate involvement" with the SEC); Villani v. New York Stock Exch., 348 F. Supp. 1185, 1188 n.1 (S.D.N.Y. 1972) (holding that Fifth Amendment due process requirements apply to disciplinary hearings of NYSE because "[s]uch hearings are conducted under the self-regulatory power conferred upon it by . . . the [SEC]"). *See also* Silver v. N.Y. Stock Exch., 373 U.S. 341, 366 (1963); Burton v. Wilmington Parking Auth., 365 U.S. 715 (1961); Clon v. Tompkins Square Neighbors, Inc., 294 F. Supp. 134 (S.D.N.Y. 1968). *See also* Richard L. Stone & Michael A. Perino, *Just a Private Club: Self-Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453, 483–84 (1995).

10. *See* Morales v. Trans World Airlines, 504 U.S. 374, 382 (1992).

11. 29 U.S.C. § 1144(a) (2002).

emption is implied and state law is therefore displaced "if federal law so thoroughly occupies a legislative field as to make reasonable the inference that Congress left no room for the states to supplement it."[12] This type of implied preemption is often referred to as field preemption. State law may be displaced under a conflict analysis if either it is impossible to comply with both a state and a federal law, or if the state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[13] An example of conflict preemption in securities law is *Edgar v. Mite Corp.,* where an Illinois takeover statute was found to conflict with the Exchange Act.[14] In all cases involving preemption, the courts look to the intent of Congress, which frequently is unclear due to the political sensitivities involved.

When the Securities Act and the Exchange Act were initially passed, Congress did not explicitly preempt state law. To the contrary, Congress inserted "savings clauses" in both the Securities Act and the Exchange Act.[15] Former Section 18 of the Securities Act provided: "Nothing in this Subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person."[16] The legislative history of this provision is sparse. However, the initial Securities Act bill, which passed the House,

12. Cipollone v. Ligget Group, Inc., 505 U.S. 504, 516 (1992). *See also* Shaw v. Delta Air Lines, 463 U.S. 85, 95–99 (1983) (finding that state laws having a connection with or reference to employee benefit plans are preempted by ERISA, with which Congress intended to preempt an entire field); Patenaude v. Equitable Life Ins., 290 F.3d 1020, 1024 (9th Cir. 2002) ("[A] statute may so completely preempt state law that it occupies the entire field, barring assertion of any state law claims and permitting removal to federal court."). In *Patenaude* the court held that a deferred tax variable annuity purchased by the plaintiff fell within the meaning of "covered security" under the Securities Litigation Uniform Standards Act ("SLUSA"), and therefore plaintiff's state law claims were appropriately discarded by the district court. *See generally id.* The Court stated: "Congress has consistently indicated its intent, particularly with the passage of SLUSA, to displace state regulation insofar as it relates to the marketing of the securities component of variable annuities." *Id.* at 1027.

13. Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977).

14. Edgar v. Mite Corp., 457 U.S. 624 (1982).

15. *See infra* notes 16–20.

16. Securities Act of 1933, ch. 38, § 18, 48 Stat. 74, 85 (codified as amended at 15 U.S.C. § 77r (2000)).

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set forth a clause prohibiting the sale of securities in interstate commerce into any state if such sale would have violated the blue-sky laws of that state.[17] The stated purpose of this prohibition was "to assure the states that the [Securities Act] was not an attempt to supplant their laws, but an attempt to supplement their laws and to assist them in enforcing their laws in those cases where they have no control."[18] This clause was later deleted by Senate amendment.[19] Former Section 28(a) of the Exchange Act was similar to former Section 18 of the Securities Act. It provided: "nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder."[20]

Although these "savings clauses" indicated a congressional intent not to preempt state blue-sky law generally,[21] the Supreme Court could nevertheless have declared that some or all state securities laws were preempted under field or conflict preemption principles. In addition to being invalidated due to federal preemption, state blue-sky legislation could have been declared invalid under the Commerce Clause. Legislation will be invalidated under the Commerce Clause if it imposes a burden on interstate commerce that is excessive in relation to the local interests served.[22] In many instances, state blue-sky regulations imposed burdens on interstate commerce. While such burdens can be justified on the ground that a state has a legitimate interest in capital investment or financial services within its borders, regulation that effectively impedes the interstate capital markets would be invalid.[23]

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17. H.R. REP. NO. 73-85, at 10–11, 25 (1933).

18. *Federal Securities Act: Hearing before the Comm. on Interstate and Foreign Commerce on H.R. 4314*, 73rd Cong. 117 (1933) (statement of Ollie M. Butler, Foreign Service Div., Dept. of Commerce).

19. *See* H.R. REP. NO. 73-152, at 27 (1933).

20. Securities Exchange Act of 1934, § 28, 48 Stat. 903 (codified as amended at 15 U.S.C. § 78bb(a) (2000)).

21. *See* Russell A. Smith, *"Blue Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135, 1160 (1936).

22. Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

23. *See* Metro. Life Ins. Co. v. Ward, 470 U.S. 869 (1985) (holding that the Alabama domestic preference tax statute violated the Equal Protection Clause); Lewis v. BT Inv. Managers, Inc., 447 U.S. 27 (1980) (deeming unconstitutional a Florida statute that prevented out-of-state bank holding compa-

The constitutionality of state blue-sky laws was first tested in three Supreme Court cases decided in 1917, sixteen years before the first federal securities law was enacted.[24] While a variety of constitutional arguments were raised in these cases, the cases particularly focused upon the possible limitations imposed by the Fourteenth Amendment on the power of a state to prevent fraudulent securities issuances. Only one of the opinions, however, specifically discussed the contention that the blue-sky laws burdened interstate commerce. In *Hall v. Geiger-Jones Co.*, the Court upheld the blue-sky statute under review, on the ground that the statute was only applicable to dispositions of securities *within* the state and, thus, could not burden interstate commerce.[25] The Court found that:

> Upon their transportation into the State there is no impediment — no regulation of them or interference with them after they get there. There is the exaction only that he who disposes of them there shall be licensed to do so, and this only that they may not appear in false character and impose an appearance of a value which they may not possess — and this certainly is only an indirect burden upon them as objects of interstate commerce, if they may be regarded as such.[26]

This reasoning clearly suggests that in-state corporations that participate in purely local financing ventures are subject to blue-sky merit regulation and that blue-sky merit regulation limited to intrastate issuances is valid. It remained an open question, however, whether this reasoning would insulate blue-sky merit regulation that had the effect of compelling an out-of-state corporation, which had registered an offering with the SEC and made the full disclosure required by federal law, to change its capitalization in order to syndicate a securities offering nationally.

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nies from owning or controlling any business within the state that sold investment advisory services); Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 329, 329–32 (1977) (invalidating a section of the New York Tax Law on Commerce Clause grounds, because law provided a "direct commercial advantage to local business" by imposing a greater tax burden on out-of-state securities transactions than on like in-state transactions).

24. *See* Hall v. Geiger-Jones Co., 242 U.S. 539 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Merrick v. N.W. Halsey & Co., 242 U.S. 568 (1917).

25. *Hall,* 242 U.S. at 539.

26. *Id.* at 557–58.

In the period between 1977 and 1987 the Supreme Court addressed securities law federalism issues in the context of drawing a line between state corporate law concerning the fiduciary duties of managers and directors and federal securities law obligations placed on public companies and their officers and directors. From a political standpoint, the Court seemed concerned with restricting the coverage of the federal securities laws, especially in the corporate governance area. In view of the Court's deference to congressional determination of the scope of the commerce power since 1937, the Court did not rest its rulings on constitutional grounds as much as on its construction of congressional intent in enacting the securities laws. Nevertheless, these decisions should be viewed as part of the Court's renewed interest in constitutional federalism as a means to constrain the growth of federal power.[27]

Beginning in the mid-1970s the Court articulated a distinction between state corporate law and the federal securities law that has long been less than clear-cut.[28] In 1995, in a non-securities law case, the Supreme Court stated: "Corporations are creatures of state laws and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stock holders, state law will govern the internal affairs of the corporation."[29]

Thereafter, in *Santa Fe Indus., Inc. v. Green*,[30] the Court applied this principle in a case arising under the federal securities laws involving a short form merger. Under Delaware law owners of at least 90% of a subsidiary's stock may merge with that subsidiary without requesting the consent of minority shareholders — who, in turn, must receive fair value for their

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27. *See* Calvin Massey, *Federalism and the Rehnquist Court*, 53 HASTINGS L.J. 431, 432–34 (2002); A. C. Pritchard, *Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998*, 78 WASH. U. L. Q. 435, 491, 494 (2000).

28. *See* Arthur Fleicher, Jr., *Federalism and Corporation Law: An Assessment*, 78 HARV. L. REV. 1146, 1179 (1965); Roberta S. Karmel, *Qualitative Standards for "Qualified Securities": SEC Regulation of Voting Rights*, 36 CATH. U. L. REV. 809 (1987); Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L. J. 545 (1984).

29. Cort v. Ash, 422 U.S. 66, 84 (1975).

30. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

shares.[31] The plaintiff, the minority shareholders in *Santa Fe*, did not allege any material misrepresentation or omission.[32] Rather, they argued that the antifraud provisions of the federal securities laws were applicable to a breach of corporate fiduciary duty, because the majority shareholders were not pursuing a legitimate corporate purpose.[33] The Court, however, refused to apply Rule 10b-5 to the allegations of "internal corporate mismanagement."[34] It stated: "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[35]

In *Schreiber v. Burlington N., Inc.,*[36] the Supreme Court indicated that *Santa Fe* would not be confined to its facts, but rather was a general holding concerning federalism. *Schreiber* raised the issue of whether the withdrawal of a hostile tender offer bid and the substitution of a partial bid, following negotiations with the target company's management, constituted a manipulative act under the Williams Act, an amendment to the Exchange Act which regulates tender offers.[37] The Court held that the term "manipulation" in sections 10(b) and 14(e) of the Exchange Act should be similarly interpreted and that manipulative acts require misrepresentation or nondisclosure.

The conflict between state law and the Williams Act also was presented to the Court in cases raising the issue of whether state statutes adopted to protect corporations against hostile takeovers were unconstitutional. At about the same time as the Williams Act was passed, a variety of state statutes sought to control bids for "local" companies by subjecting such bids to administrative delays and permitting a state securities commissioner to determine the fairness of the bid. In the 1982 case of *Edgar v. MITE Corp.* the Supreme Court held such a state se-

31. DEL. CODE ANN. tit. 8, §§ 253, 262 (2001).

32. *Santa Fe*, 430 U.S. at 474.

33. *Id.*

34. *Id.* at 479.

35. *Id.*

36. Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985).

37. The Williams Act, which regulates tender offers, is contained in sections 13(d)–(e) and 14(d)–(f) of the Exchange Act, 15 U.S.C. §§ 78m(d)–(e) (2002); 15 U.S.C. §§ 78n(d)–(f) (2002) and the regulations thereunder, 17 C.F.R. §§ 240.13d-1 to 13e-101, 240.14a-1 to 14f-1.

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curities regulatory statute — the Illinois takeover law — inconsistent with the U.S. Constitution.[38] There were six separate opinions issued in this case, and a majority found only that the state law imposed an indirect burden on interstate commerce.[39] A plurality of Justices found direct burdens on commerce,[40] and another plurality found preemption of the state law by the Williams Act.[41] The Court explained that its traditional rationale for upholding state blue-sky laws against commerce clause invalidity "was that they only regulated transactions occurring within the regulating States."[42] The Court stated, however, that the Illinois regulatory scheme went beyond regulating intrastate transactions.[43] In *CTS Corp. v. Dynamics Corp. of America*,[44] a subsequent case raising the issues of whether a state control share statute was unconstitutional under the Supremacy or Commerce Clauses, the Supreme Court upheld an Indiana statute because: (1) it preserved the neutrality of the Williams Act; (2) left to shareholders the decision whether to accept the offer; and (3) regulated internal corporate affairs.[45]

It is frequently stated that SROs exercise delegated governmental authority.[46] In fact, stock exchange regulation preceded the federal securities laws and SEC oversight was overlaid upon an existing regulatory framework. The NASD was established pursuant to an amendment to the Exchange Act and all SEC registered broker-dealers are required to be NASD mem-

38. Edgar v. MITE Corp., 457 U.S. 624 (1982).

39. *Id.* at 643–46.

40. *Id.* at 641–43.

41. *Id.* at 630–34.

42. *Id.* at 641 (citing Hall v. Geiger-Jones Co., 242 U.S. 539 (1917)).

43. *Id.*

44. CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987).

45. *See id.* at 82, 83, 91, 94.

46. *See, e.g.,* Silver v. N.Y. Stock Exch., 373 U.S. 341, 366 (1963) (describing the relationship between the New York Stock Exchange and the SEC as "a type of *partnership* between government and private enterprise") (emphasis added); Bruan, Gordon & Co. v. New York Stock Exchange, 502 F. Supp. 897, 903 (S.D.N.Y. 1980) (describing the NASD as "an arm or agent" of the SEC); Stephen J. Ware, *Employment Arbitration and Voluntary Consent,* 25 HOFSTRA L. REV. 83, 154 (1996); Richard L. Stone & Michael A. Perino, *Not Just a Private Club: Self-Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453, 483–84 (arguing that, because Congress has delegated substantial powers to SROs in securities matters, SROs should be deemed state actors when enforcing federal law under the Exchange Act).

bers.[47] Therefore, NASD regulation, in contrast to stock exchange regulation, can more appropriately be viewed as delegated governmental regulatory authority. An important reason for putting the SEC umbrella over SRO activity is that this gives SROs qualified immunity from the antitrust laws.[48]

The relationship between the SEC and SROs raises some interesting constitutional questions that have never been tested. Can an administrative agency with delegated authority subdelegate that authority to SROs? Should SRO regulations be viewed as state law or federal law? Is there a difference between listing standards, which were once a matter of contract between exchanges and listed companies, and regulations of stock exchange members and stock markets?

The uncertain status of stock exchange listing standards was tested in *Business Roundtable v. SEC,* in which the U.S. Court of Appeals for the District of Columbia ("D.C. Circuit Court") abrogated an SEC rule attempting to impose a uniform voting rights standard upon all national marketplaces.[49] The court found that the SEC regulation was a "rule" under Sections 19(b) and 19(c) of the Exchange Act,[50] but that it was not in furtherance of the purposes of the Exchange Act.[51] The court's rationale was that there was no indication in the statute that Congress intended to permit such a broad federal preemption over corporate governance and shareholder rights — matters traditionally left to state law.[52] Presumably, however, the exchanges could have adopted the SEC's rule as a matter of non-federal

47. The NASD was created under the authority of Section 15A of the Exchange Act, 15 U.S.C. § 78o-1 (2000). See Roberet N. Rapp, *Rethinking Risky Investments for That Little Old Lady: A Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers*, 24 OHIO N.U. L. REV. 189, 197 n.32 (1998).

48. *See* Gordon v. N.Y. Stock Exch., 422 U.S. 659 (1975).

49. Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

50. *Id.* at 409. Under section 19(b), SROs are required to receive SEC approval of any and all new rules and any proposed changes to existing rules. 15 U.S.C. § 78s(b)(1). The Commission then either approves the proposed rule, or schedules a hearing in order to decide whether a proposal will be accepted. *Id.* § 78s(b)(2). Under section 19(c), the Commission also retains the authority to itself amend the rules of a self-regulatory organization, "as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization." *Id.* § 78s(c).

51. *Business Roundtable*, 905 F.2d at 410–17.

52. *Id.*

law, and they subsequently did so.[53] Nevertheless, the SEC was required under the Exchange Act to approve these "voluntary" rules.[54]

B. Deregulation through Statutory Preemption

While the Supreme Court was allocating regulatory responsibility for takeovers and other corporate restructurings based on whether statutes involved matters of express federal policy regarding the protection of investors or internal corporate governance, the securities industry was advocating preemption of state blue-sky laws concerning securities offerings and the regulation of broker-dealers and investment advisers. This move to preempt state blue-sky laws found favor in the deregulatory politics of Presidents Ronald Reagan and George H.W. Bush, and the Contract with America advocated by Newt Gingrich.[55] Initially, complaints concerning duplication and inconsistency of unnecessary regulatory burdens were answered by a 1980 statute[56] adding Section 19(c)(1) to the Securities Act authorizing the SEC to cooperate with state government representatives in securities matters to achieve effective, uniform securities regulations with a minimum interference with the business of capital formation.[57] The statute mandated an annual conference of SEC and state regulators for the purpose of developing uniform securities forms and procedures and a small issues ex-

53. *See* Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 346 (2001).

54. Exchange Act § 19(b), 15 U.S.C. § 78s(b) (2000). *See also* Self-Regulatory Organizations, Exchange Act Release No. 34-27,554, 54 Fed. Reg. 53,227 (Dec. 27, 1989) (release by which the SEC approved NYSE's original voting rule); Self-Regulatory Organizations, Exchange Act Release No. 34-28,517, 55 Fed. Reg. 41,626-01 (Oct. 12, 1990) (release by which SEC approved NASD's adoption of the former SEC Rule 19b-4); Douglas C. Michael, *Untenable Status of Corporate Governance Listing Standards under the Securities Exchange Act,* 47 BUS. LAW 1461, 1472 n.70 (1992) ("[A]lthough [SEC] Rule 19c-4 is invalid, its verbatim counterpart adopted by the NYSE still binds listed companies.").

55. *See* Pritchard, *supra* note 27, at 436 n.5; Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 29 (1998).

56. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, Sec. 505, § 19(c), 94 Stat. 2275, 2292–93 (adding Section 19(c) of the Securities Act).

57. 15 U.S.C. §§ 77s(d)(1)–(2) (2000).

emption from registration.[58] Whether this act could have mandated the states to develop such forms, procedures and exemptions is unclear under constitutional federalism.[59] Further, the act provided that "[n]othing in this Act shall be construed as authorizing preemption of State law."[60]

Pursuant to this directive the SEC worked with the North American Securities Administrators Association ("NASAA") to develop a state law uniform limited offering exemption ("ULOE"). By 1996, thirty-eight states had adopted a form of ULOE and ten other states had similar exemptions.[61] A uniform system of registration for securities salesmen was also worked out with the NASD.[62] However, there was considerable securities industry dissatisfaction with the slow and essentially voluntary progress of the SEC and NASAA in achieving uniform regulations pursuant to Section 19(c).[63]

Much more sweeping deregulation of the state blue-sky laws through preemption was accomplished in the late 1990s, first by the National Securities Markets Improvements Act of 1996

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58. *Id.* §§ 77s(d)(3)–(4).

59. Such action appears to be unconstitutional "commandeering" of states by federal government. *See* Massey, *supra* note 27, at 433–34; Printz v. United States, 521 U.S. 898, 935 (1997) (holding that Congress cannot compel states to enact a federal regulatory program); New York v. United States, 505 U.S. 144 (1992). Yet, it is unclear whether Congress might be able to accomplish this goal through preemption. *See* Massey, *supra* note 27, at 453–63, 505–06, 512–13. Recently, Congress adapted a more pointed threat of preemption of state insurance regulation of agents in the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 321, 113 Stat. 1338, 1422–24 (1999).

60. 15 U.S.C. §77s (c)(3)(C).

61. *See* THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 4.19 (4th ed. 2002).

62. *See* Securities Uniformity: Annual Conference on Uniformity of Securities Law, Securities Act. Release No. 33-7050, 56 S.E.C. Docket 764 (Nov. 2, 1994), *available at* 1994 WL 95225.

63. *State Regulators Adopt Model Commodity Code,* 17 Sec. Reg. & L. Rep. (BNA) No. 15, at 622 (Apr. 12, 1985); 12 JOSEPH C. LONG, BLUE SKY LAW § 7:32, at 7-71 to 7-73 (2002); Hugh H. Makens, et al., *Blue Sky Practice Part I: Doing it Right: Avoiding Liability Arising from State Private Offerings under ULOE and Limited Offering Exemptions, in* AMERICAN LAW INSTITUTE-AMERICAN BAR ASSOCIATION, REGULATION D OFFERINGS AND PRIVATE PLACEMENTS 271, 280 (2001); David F.E. Banks, *Hawaii Response to Regulation D,* 23 HAWAII B.J. 1, 3 (1991); Mark A. Sargent & Hugh H. Makens, *ULOE: New Hope, New Challenge,* 45 BUS. LAW. 1319, 1319–20 (1990).

("NSMIA")[64] and then by the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").[65] The NSMIA preempted state securities law in three areas. First, it preempted blue-sky securities registration, merit review and prospectus disclosure requirements for SEC registered investment companies and stock exchange and Nasdaq listed securities. It also preempted blue-sky law in most private placements.[66] Prior to the NSMIA, blue-sky laws all contained a requirement for registration of securities, but most state laws had an exemption from their registration requirements for issuers listed on a national securities exchange.[67] The NASD had lobbied for Nasdaq listed securities to be similarly exempt, but the NASAA wished for greater control over the criteria for a blue chip exemption.[68] The NSMIA essentially mandated a blue chip exemption for all nationally traded securities. This preemption did not completely eliminate merit standards because the NASD regulates underwriting terms and conditions with respect to offerings underwritten by broker-dealers.[69] Further, this SRO regulation is a uniform national standard. Whether it is federal law or state law is an interesting question.

Second, the NSMIA preempted state regulation of broker-dealers with respect to capital, custody, margin, financial responsibility, records, bonding and reporting requirements to the extent inconsistent with federal law.[70] Third, the SEC was given exclusive regulatory authority over investment advisers to SEC registered investment companies and advisers with $25 million or more in assets under management.[71] The differing language used by Congress in preempting state regulation of

64. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.)

65. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.).

66. 15 U.S.C. §77r (2000).

67. Sargent, *supra* note 3, at 833–35.

68. *See NASAA Proposes '56 Uniform Act Amendments at Spring Meeting*, 18 Sec. Reg. & L. Rep. (BNA) No. 12, at 399 (Mar. 21, 1986).

69. Conduct Rule 2710–2730, N.A.S.D. Manual, at 4501–31.

70. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, § 103(a), 110 Stat. 3416, 3420–22 (codified as amended at 15 U.S.C. §78o(h)(1) (2000)).

71. The Investment Adviser Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2000).

broker-dealers and investment advisers is of interest. With respect to broker-dealers, the NSMIA provided that:

> No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under this title.[72]

Although state licensing of persons associated with broker-dealers was not preempted, the SEC was directed to conduct a study of the impact of disparate state licensing requirements for such persons.[73]

With respect to investment advisers, the NSMIA provided that "[n]o law of any State or political subdivision thereof requiring the registration, licensing, or qualification as an investment adviser . . . shall apply to any person . . . that is registered [with the SEC] as an investment adviser."[74] Further, advisers exempt from the definition of "investment advisor" in the federal securities laws were similarly exempt.[75] Associated persons could be licensed or registered only if any such person had a place of business within a state.[76] The preemption of state regulation of SEC regulated broker-dealers and investment advisers and their associated persons was not complete. The states retained authority to investigate and bring enforcement actions for fraud or deceit or other unlawful conduct by a broker-dealer or investment adviser or their associated persons.[77]

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72. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, § 103(a), 110 Stat. 3420, (codified as amended at 15 U.S.C. §78o(h)(1) (2000)).

73. *See id* § 510(d), 110 Stat. 3416, 3451. *See also* Susan S. Krawczyk, *Recent Developments of Interest to Sellers of Variable Insurance Products, in* AMERICAN LAW INSTITUTE-AMERICAN BAR ASSOCIATION, CONFERENCE ON LIFE INSURANCE COMPANY PRODUCTS: CURRENT SECURITIES, TAX, ERISA, AND STATE REGULATORY ISSUES 239, 252–55 (1998) (discussing the objectives and conclusions of the study).

74. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290, sec. 303, §203A(b)(1)(A), 110 Stat. 3416, 3437 (codified as amended at 15 U.S.C. § 80b-3a(b)(1)(A) (2000)).

75. *Id.*

76. *Id.*

77. 15 U.S.C. § 80b-3a(b)(1) (2000).

The congressional justification for the preemption provisions of the NSMIA was that the system of dual federal and state securities regulation was unnecessary, because it was redundant, costly and ineffective.[78] Therefore regulatory responsibility was allocated based on the nature of the securities offering.[79] Inherently national offerings were made subject only to federal regulation.[80] There is some irony to such sweeping preemption of state law emanating from a Republican Congress supposedly committed to lessening federal regulation, but the NSMIA was a deregulatory statute favored by business groups.[81]

The SLUSA was even more deregulatory and its way of effecting preemption was more radical. It was adopted as a reaction against attempts to evade the obstacles to federal securities class actions erected by the Private Securities Litigation Reform Act of 1995 ("PSLRA")[82] by using state court class actions. The PSLRA did not change the provisions of the law covering securities anti-fraud actions, but it made plaintiff class action suits more difficult by, among other things, reducing the control of plaintiff's counsel over class action litigation;[83] imposing stricter pleading standards[84] and providing a safe harbor for forward looking information.[85] These procedural reforms were aimed at curbing abusive litigation in the federal courts; they left state

78. H.R. CONF. REP. NO. 104-864, at 39 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3920, 3920–21.

79. *Id.* at 40.

80. *Id.*

81. *See* Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies for Securities Fraud*, 60 LAW & CONTEMP. PROBS. 169, 170 (1997).

82. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.).

83. "Appointing lead plaintiff on the basis of financial interest, rather than on a 'first come, first serve' basis, was intended to endure that institutional plaintiffs with expertise in the securities market and real financial interests in the integrity of the market would control the litigation, not lawyers." *In re* Donnkenny, Inc. Sec. Litig., 171 F.R.D. 156, 157 (S.D.N.Y. 1997) (citing H.R. CONF. REP. NO. 104-369, at 31–35 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730–34). Also, there is a stay of discovery while a motion to dismiss is pending. 15 U.S.C. §78u-4(b)(3)(B) (2000).

84. Specific factual allegations raising a strong inference of scienter must be pled. 15 U.S.C. §78u-4(b)(3)(B) (2000).

85. 15 U.S.C. §78u-5 (2000).

securities fraud actions alone.[86] Some plaintiffs' lawyers reacted by bringing class actions in securities fraud cases in state courts, particularly in California.

High technology companies and other business groups then lobbied for federal preemption on the grounds that the PSLRA was being undermined and Congress obliged.[87] Finding that national uniformity was preferable to fragmentation because of the need for predictability,[88] Congress engaged in selective preemption by depriving state courts of the power to adjudicate securities fraud class actions in cases involving securities listed on a national stock exchange or the Nasdaq. The SLUSA provides that no class action based on state law alleging fraud in connection with the purchase or sale of a "covered security" may be maintained in state or federal court and any such action shall be removable to a federal district court and dismissed.[89] Although the Congress that passed the SLUSA was generally committed to federalism, it found that promoting efficient national securities markets was a more convincing and compelling interest than reinforcing state rights.[90]

Although the Republican majority succeeded in pushing through the SLUSA, there were strong dissents by Democrats in both the Senate and the House. Senators Sarbanes, Bryan, and Johnson pointed out that roughly 60% of state class action suits filed after the PLSRA were filed in California and although one state should not set a "pro-plaintiff" national standard for securities fraud, Congress should not second-guess California judgments in balancing the interests of local businesses against the interests of local investors.[91] Dissenters in the House similarly felt this avoidance of the PLSRA was a problem for the California legislature. Further, they pointed out the irony in "the Republican-led Congress that campaigns

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86. *See* Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 287 (1998).

87. *See* Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 64 CORNELL L. REV. 1, 4–5 (1998).

88. *See* S. REP. NO. 105-182, at 3 (1998).

89. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, sec. 101, § 16, 112 Stat. 3227 (codified as amended at 15 U.S.C. § 77p(b)–(c) (2000)).

90. *See* S. REP. NO. 105-182, at 5.

91. *Id.* at 13.

on returning power to the states and protecting individual choice [championing] a federal mandate abolishing important state prerogatives along with protections and rights."[92]

C. Preemption of State Common Law in the Payment for Order Flow Cases

Payment for order flow is the remuneration in the form of monetary or other benefits given to retail securities broker-dealers for routing customers' orders for execution to particular wholesale dealers, market makers, or exchanges.[93] With the advent of computer advances and automated trading systems, this practice became increasingly widespread in the 1980s and 1990s,[94] although it may have diminished as a result of securities trading decimalization.[95] Payment for order flow is a controversial practice.[96] At one extreme it could be viewed as commercial bribery. At the other extreme it could be viewed as welcome competition to the monopolistic trading practices of the stock exchanges and the NASD.[97] In any event, it raises questions about whether payment for order flow arrangements are inconsistent with a broker's duty of best execution. There also has been controversy as to whether payment for order flow should be abolished or be regulated by federal or state law.[98]

Concerned with the "securities industry's languor," such as "misallocation of capital, widespread inefficiencies, and unde-

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92. H. R. REP. NO. 105-640, at 46 (1998).

93. Payment for Order Flow, Exchange Act Release No. 34-34,902, 59 Fed. Reg. 55,006, 55,008 (Nov. 2, 1999).

94. Payment for Order Flow, Exchange Act Release No. 34-33,026, 58 Fed. Reg. 52,934, 52,936 (Oct. 6, 1993). *See also* SEC, DIVISION OF MARKET REGULATION, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS 8-9 (1994).

95. Since decimalization lowered spreads, the incentive for payment for order flow arrangements decreased. *See Unger, Exchange Officials Testify Decimals Have Affected Depth, Liquidity of Trading,* 33 Sec. Reg. & L. Rep. (BNA) No. 21, at 803 (May 28, 2001).

96. Payment for Order Flow, Exchange Act Release No. 34-33,026, 58 Fed. Reg. 52,934, 52,935 (Oct. 6, 1993).

97. *See* Self-Regulatory Organizations, Exchange Act Release No. 34-19,047, 47 Fed. Reg. 41,896 (Sept. 22, 1982). For a review of the debate concerning payment for order flow, see Note, *The Perils of Payment for Order Flow*, 107 HARV. L. REV. 1675 (1994).

98. *See id.*

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sirable and potentially harmful fragmentation of trading,"[99] in 1975 Congress enacted extensive amendments to the Exchange Act and directed the SEC to facilitate the development of a national market system to promote efficiency and fair competition in the securities industry. Pursuant to this mandate, the SEC adopted Rule 10b-10 in 1977, which required brokers and dealers to disclose, among other things, the amount of remuneration received and the source and amount of any other remuneration received.[100] The 1977 version of Rule 10b-10 did not specifically mention order flow as one of the "other remunerations."[101]

The growth and pervasiveness of the practice, however, aroused extensive debate over its merits and harms. In response, the SEC conducted a comprehensive study of order flow payments. The SEC concluded that the practice produced the following economic benefits to customers: lower unit costs; increased retail brokerage firm revenues; lowered commissions; more expeditious executions; enhanced customer services; increased competition from automated execution systems and related practices; increased competition between wholesale dealers and exchanges and vertically integrated firms; and reduced execution costs in all markets, including the exchanges.[102] The SEC also recognized the opposing concerns as to the possible conflict of interest and breach of duty of best order execution.[103]

In an attempt to address the issue with more particularity, the SEC amended Rule 10b-10 in 1994.[104] The amended Rule 10b-10, which became effective in October 1995, defined order flow payment as any form or arrangement compensating brokers or dealers in return for the routing of orders.[105] The SEC rejected as too burdensome and unworkable proposals that order flow payments be passed through to the customers,[106] as well as its own initial proposal that brokers disclose the amount

99. S. REP. NO. 94-75, at 1 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 180.
100. 17 C.F.R. § 240.10b-10 (2002).
101. *See* Exchange Act Release No. 34-13,508, 12 S.E.C. Docket No. 299 (May 5, 1997).
102. Payment for Order Flow, Exchange Act Release No. 34-33,026, 58 Fed. Reg. 52,934, 52,939–40 (Oct. 13, 1993).
103. *Id.* at 52,936–37.
104. *See* Payment for Order Flow, Exchange Act Release No. 34-34,902, 59 Fed. Reg. 55,006 (Nov. 2, 1994).
105. *Id.* at 55,008.
106. *Id.* at 55,010–11 n.42.

of payments for order flow.[107] Amended Rule 10b-10, however, requires a broker-dealer to disclose in each transaction confirmation slip whether payment for order flow was received, and that the source and nature of the payment would be available at the customer's request.[108] In addition, the SEC adopted a new rule, 11Ac1-3, which requires annual disclosure to customers of a broker's or dealer's policies regarding receipt of payments for order flow, the market makers to which customer orders are routed, and the aggregate amount of payments received for order flow in the previous year.[109]

Subsequently, payment for order flow was tested in a number of state courts in cases claiming breach of fiduciary duty. The highest courts of New York,[110] Minnesota,[111] Illinois,[112] and Pennsylvania,[113] as well as two other states' intermediate appellate courts[114] found that the 1975 amendments to the Exchange Act and SEC disclosure regulations impliedly preempted state common law regarding any breach of fiduciary duty involved in payment for order flow practices.[115] Courts that considered the issue of payments for order flow found express preemption principles inapplicable because no clear language indicated such a congressional preemptive intent.[116] The question then became whether and what kind of implicit preemption could be inferred. In their determinations, courts devoted most of their attention to the history of the Exchange Act, as amended in 1975, and the evolution of SEC regulations relevant to order flow payments.[117] The Supreme Court of Minnesota and the New York Court of

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107. *Id.* at 55,010 n.39.

108. *Id.* at 55,010.

109. 17 C.F.R. § 240.11Ac1-3 (2002).

110. Guice v. Charles Schwab & Co., 674 N.E.2d 282 (N.Y. 1996).

111. Dahl v. Charles Schwab & Co., 545 N.W.2d 918 (Minn. 1996).

112. Orman v. Charles Schwab & Co., 688 N.E.2d 620 (Ill. 1997).

113. Shulick v. PaineWebber & Co., 722 A.2d 148 (Pa. 1998).

114. Eirman v. Olde Discount Corp., 697 So. 2d 865 (Fla. Dist. Ct. App. 1997); Mickey v. Charles Schwab & Co., 79 Cal. Rptr. 2d 213 (Cal. App. 1998).

115. Some critics argued that these cases holding preemption of state law threatened the dual securities regulatory regime Congress intended to preserve. *See, e.g.,* Anthony Szydlowsky, *Comment, Preemption In The Securities Industry: A Diminished Standard?* 74 ST. JOHN'S L. REV. 259, 261 (2000) (arguing that *Guice* was decided incorrectly and created a bad preemption analysis, that Congress explicitly preserved state law causes of action).

116. *See Dahl*, 545 N.W.2d at 923–24.

117. *See, e.g., id.* at 921–24.

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Appeals were among the earliest to find preemption of state law in payment for order flow cases.[118]

In *Dahl v. Charles Schwab,* Minnesota's highest court rejected both the plaintiffs' and the defendant's theory of express preemption.[119] The court held that implicit preemption, specifically under the obstacle principle, was applicable to the case.[120] The court was very concerned with the national, and even international, ramifications of its decision, since payment for order flow was pervasive in the securities industry.[121] Although complying with both state and federal disclosure requirements was not entirely impossible, the court reasoned, it was expensive and difficult for brokers to determine order flow payments on a case-by-case basis.[122] Usually, such payments were made on an aggregate basis, and remuneration could take the form of research service or other non-monetary services. Therefore, requiring broker-dealers to disclose the amount of each individual order flow payment as the plaintiffs urged would operate to terminate the practice, which the SEC found to have produced more benefits than harms to investors.[123] The court concluded that since a state law cause of action could frustrate the national market system objectives of the SEC and Congress, it was impliedly preempted.[124]

Six months later, in *Guice v. Charles Schwab* the New York Court of Appeals agreed with the *Dahl* court's decision.[125] That court — the highest in New York — performed a similarly thorough analysis of the legislative history of the 1975 amendments to the Exchange Act and the SEC's relevant regulations.[126] The court emphasized the agency's acknowledgment that order flow payments furthered the purposes of Congress by enhancing more efficient and less costly execution of customers' orders and by promoting competition for order executions among all markets.[127] The court maintained that the SEC regulations regard-

118. *See supra* notes 110–11.
119. *Dahl*, 545 N.W.2d at 922–24.
120. *Id.* at 925.
121. *See id.* at 925–26.
122. *Id.* at 925.
123. *Id.*
124. *Id.* at 925–26.
125. Guice v. Charles Schwab & Co., 674 N.E.2d 282, 290 (N.Y. 1996).
126. *See id.* at 286–87.
127. *Id.* at 289–90.

ing disclosure requirements were less stringent than the applicable state common law.[128] A mandatory disclosure of specific monetary receipts, in its view, might have a deleterious effect on the securities industry.[129] Securities broker-dealers, facing potentially nationwide class action civil liability, would be compelled to comply with the different disclosure requirements of each individual state. The resulting chaos in the securities regulatory regime would frustrate the Congress's intent of establishing a nationally "coherent and rational regulatory structure" under the leadership of the SEC.[130] Because state law would interfere with the methods by which the federal statute was designed to reach a congressional goal, it was preempted.[131] As for the effect of the savings clause, the court interpreted it as negating only implied field preemption, not conflict preemption.[132]

Other courts followed the reasoning of the *Dahl* and *Guice* courts. The Illinois Supreme Court in *Orman v. Charles Schwab* noted that the SEC in the 1994 amendments to Rule 10b-10 had "struck a deliberate balance" by requiring broker-dealers to provide investors with key information while rejecting "impractical and burdensome disclosure requirements that might compromise the contributions of the practice to market competition."[133] Significantly, even though the 1994 amendments to Rule 10b-10 were not in effect at the time of the defendants' challenged practice, the court found these amendments "instructive as to the scope of the 1977 version of Rule 10b-10."[134] Citing *Guice* and *Dahl* the *Orman* court held that the plaintiffs' state claims obstructed the purposes and objectives of the Congress and thus were preempted.[135]

In *Shulick v. PaineWebber*, the Supreme Court of Pennsylvania also found the *Guice* court's rationale convincing.[136] The majority in *Shulick* emphasized that the purpose of Rule 10b-10 was to establish uniformity in the disclosure requirements per-

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128. *See id.* at 290.
129. *See id.*
130. *Id.*
131. *Id.* at 291.
132. *Id.* at 291–92.
133. *Orman*, 688 N.E.2d at 623.
134. *Id.* at 626.
135. *Id.*
136. *Shulick*, 722 A.2d at 151.

taining to order flow payments.[137] However, as the concurring opinion pointed out, the majority's preemption theory was field preemption, differing from *Guice's* implied conflict preemption.[138] The majority stated that "federal regulation of the narrow subject of disclosure of order flow payments is so thorough that we have no difficulty finding the "reasonable inference . . . that no room has been left for a state to impose additional requirements."[139] The concurring opinion questioned the soundness of this theory, finding it inappropriate to apply field preemption to a particular issue within securities regulation rather than the field as a whole.[140]

In *McKey v. Charles Schwab*, the court adopted the implied preemption theory.[141] The court admitted that the preemptive intent evidenced by the 1994 amendments to Rule 10b-10 and the new rule 11Ac1 were not applicable before October 1995, the time of the challenged practice.[142] However, it found the old Rule 10b-10 dispositive.[143] The fact that the old rule did not specifically mention order flow payments, in the *McKey* court's view, did not mean that the rule was inapplicable.[144] The court believed that the old rule clearly evidenced an intent by the SEC to "regulate any and all remuneration received by brokers,

137. *See id.* at 149.

138. *See id.* at 152 (Cappy, J., concurring).

139. *Id.* at 151.

140. Two other states' intermediate courts also have held federal securities law preempted state law by implication. In *Eirman v. Olde*, 697 So. 2d 865 (Fla. Dist. Ct. App. 1997), the District Court of Appeal of Florida for the Fourth District found the reasoning of *Guice, Dahl,* and *Orman* to be persuasive and declined to follow two 1995 cases that reached different decisions. *See id.*; Dumont v. Charles Schwab & Co., 1995 WL 262262 (E.D. La. 1995), *rev'd*, 717 So.2d 1182 (9th Cir. 1998); Thomas v. Charles Schwab & Co., 1995 WL 626522, at *2 (W.D. La. 1995). *See also* Gilman v. Wheat, First Securities, Inc. 896 F. Supp. 507 (D. Md. 1995). In *Dumont*, the U.S. District Court for Eastern Louisiana, decided that there was no diversity and no federal question because there was no complete federal preemption of the field of securities. *See Dumont*, 1995 WL 262262, at *2. In *Thomas,* the Tenth Judicial District Court for the Parish of Nachitoches, Louisiana found no express preemption nor inferred congressional preemptive intent. *See Thomas,* 1995 WL 626522, at *2.

141. McKey v. Charles Schwab, 79 Cal. Rptr. 2d 213, 219 (Cal. Ct. App. 1998).

142. *Id.* at 214–15, 219.

143. *Id.* at 219.

144. *Id.*

no matter what the form."[145] In addition, the *McKey* court adopted *Guice's* rationale that allowing each state to enforce its own disclosure requirements would disturb the promotion of a national market system, a goal expressed in the 1975 amendments to the Exchange Act.[146]

In short, the majority of the state courts that considered cases alleging that payment for order flow was a breach of fiduciary duty have held that federal law and regulations impliedly preempted state law. Except for the Supreme Court of Pennsylvania, which found field preemption, all other courts found implicit conflict preemption, because permitting state common law cases to go forward would present an obstacle to the national market system mandated by the Exchange Act.

D. The Resurgence of State Securities Regulators

On May 21, 2002, New York State Attorney General Eliot Spitzer announced an agreement by Merrill Lunch to enact significant and immediate reforms to insulate securities research analysts from its investment banking division and to change the way analysts are compensated.[147] Under this settlement, Merrill Lynch agreed, among other things: to sever the link between compensation for analysts and that for investment banking; prohibit investment banking input into analysts' compensation; to create a new investment review committee responsible for approving all research recommendations; to disclose in its research reports whether it has received or is entitled to receive any compensation from a covered company over the past 12 months; and to pay a $100 million fine.[148] A NASAA task force chaired by New York, California, and New Jersey led the investigation leading to this settlement.[149] The agreed upon fine is $48 million payable to the New York State Department of Law, $50 million to the remaining 49 states, the District of Columbia,

145. *Id.* at 219 n.6.
146. *Id.* at 219.
147. Press Release, Office of N.Y. State Attorney General Eliot Spitzer, N.Y. State Dep't of Law, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices (May 21, 2002), *at* http://www.oag.state.ny.us/press2002/may/may21a_02.html.
148. *Id.*
149. *Id.*

and Puerto Rico, and $2 million to NASAA.[150] This fine is only required to be paid, however, if all 50 states, the District of Columbia, and Puerto Rico agree.[151] The settlement agreement between the New York Attorney General and Merrill Lynch goes into considerable detail as to how Merrill Lynch analysts will be compensated in the future and the types of disclosures research reports will contain.[152] This case is a prime example of regulation by prosecution. Although the settlement does not by its terms apply to the entire securities industry, there are similar ongoing investigations of other firms that could result in similar settlements.[153]

The case against Merrill Lynch brought by the New York Attorney General was based on broad and general antifraud provisions of the Martin Act, which prohibit any device scheme or artifice to defraud or obtain money by means of any false pretense, representation or promise, fictitious or pretended purchase or sale, any concealment, suppression, fraud, false pretense or false promise in connection with the sale of securities or offering investment advice.[154] In the New York Attorney General's view, in contrast to the requirements of the federal securities laws, no purchase or sale of stock is required, nor are intent, reliance or damages required elements of a violation.[155] The gist of the Merrill Lynch case was that the internet research analysts at Merrill Lynch regularly published ratings for internet stocks that were misleading because: (1) the ratings in many cases did not reflect true opinions; (2) no "reduce" or "sell" recommendations were ever issued; and (3) Merrill Lynch did

150. Agreement Between the Attorney General of the State of N.Y. and Merrill, Lynch, Pierce, Fenner & Smith, Inc., May 21, 2002 ¶ 24, *available at* http://news.findlaw.com/wsj/docs/merrilllynch/nymerrill52102agr.pdf.

151. *Id.*

152. *Id.* at ¶¶ 5–11, 15.

153. *See* Charles Gasparino, *Deals & Deal Makers: Citigroup Suggests Rules for Analysts,* WALL ST. J., July 15, 2002, at C5; Charles Gasparino, *Cleaning Up Wall Street: Morgan Stanley Goes to Washington,* WALL ST. J., June 21, 2002, at C1 [hereinafter Gasparino, *Cleaning Up Wall Street*].

154. N.Y. GEN. BUS. LAW § 352(i) (McKinney's 1996).

155. Aff. in Support of Application for an Order Pursuant to General Business Law 354, at 7, *In re* Eliot Spitzer (N.Y. Sup. Ct. N.Y. County Apr. 2002) (No. 02-4015-22), *at* http://news.findlaw.com/hdocs/docs/merrilllynch/nyagmerrill0402aff.pdf.

not disclose that the analysts were acting as quasi-investment bankers for the companies rated.[156]

The role and conduct of securities analysts during the boom years of the 1990s were subject to criticism and scrutiny by securities regulators before the New York Attorney General sued Merrill Lynch. As a result of the congressional hearings after the collapse of Enron Corp., the SROs developed new regulations governing analysts' conflicts of interest, which the SEC approved in May 2002.[157] The rules prescribe mandatory disclosures about analysts' conflicts of interest and prohibit analysts from receiving compensation directly tied to investment banking fees.[158] After the action by the New York Attorney General, Congress enacted the Sarbanes-Oxley Act of 2002, which contains provisions to improve the objectivity of research analysts.[159] The SEC, or SROs under the authorization and direction of the SEC, are required to adopt rules addressing analysts' conflicts of interest by erecting firewalls between analysts and investment bankers and by mandating disclosures of analysts' conflicts of interest.[160]

The action by the New York Attorney General against Merrill Lynch was controversial. House Financial Services Committee Chairman Michael Oxley criticized the case as duplicative regulation threatening to undermine the national securities regulatory regime and that it had the capability of balkanizing the securities industry.[161] The securities industry generally favors

156. *Id.* at 3.

157. *See SEC Gives Nod to Analyst Rules Aimed at Boosting Independence,* 34 Sec. Reg. & L. Rep. (BNA) No. 19, at 749 (May 13, 2002); Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the NASD and NYSE, Securities Exchange Act Release No. 34-45,908, 67 Fed. Reg. 34,968-01 (May 15, 2002).

158. *See* NYSE Rule 472, 2 N.Y.S.E. Guide (CCH) ¶ 2472 (1995) (amended); NASD Rule 2210, N.A.S.D. Manual, at 4171–80 (new). *See also* Order Approving Proposed Rule Changes and Notice of Filing and Order Granting Accelerated Approval, Exchange Act Release No. 34-45,908, 67 Fed. Reg. 34,968 (May 16, 2002).

159. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

160. *Id.* § 501(a).

161. *See* Press Release, House Comm. on Financial Services, Oxley Comments on Spitzer Testimony (June 26, 2002), *available at* http://financialservices.house.gov/news.asp. *See also Spitzer Spars With Ox-*

national regulation rather than regulation by 50 states. The Securities Industry Association took the position that "the U.S. needs a national securities framework from which to work, not a patchwork."[162] Morgan Stanley lobbied to attach a provision preempting state securities regulators from examining securities analysts' conflicts of interest, but such a provision was not included in the Sarbanes-Oxley Act of 2002.[163] The new activism of state prosecutors against business is widespread and — as is exhibited by the Merrill Lynch case — has its roots in local governments' efforts to protect consumers against the deregulatory initiatives of the Reagan administration.[164] Defenders of the case against Merrill Lynch claim that the states have stepped in to fill the void left by weak federal regulation.[165] Eliot Spitzer, in justifying his activism, claimed that "the SEC was not doing enough."[166]

Within a year following the enactment of the Sarbanes-Oxley Act, the SEC is required to adopt or compel the SROs to adopt new regulations governing the conduct of securities analysts.[167] Although Congress did not directly preempt state action against securities analysts, issues of implied or field preemption could arise as a result of disparities between state securities regulators' views of analysts' conflicts and those of the SEC. Furthermore, not all state securities regulators agree with Spitzer's approach; therefore, there could be fragmentation and inconsistency in state securities regulation.[168]

The battle between the SEC and NASAA, as is true of many battles over national versus state or federal regulation, is politi-

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ley, Baker After Urging Tough Conflict Rules, 34 Sec. Reg. & L. Rep. (BNA) No. 26, at 1042 (July 1, 2002).

162. *See* Susanne Craig, *Local Enforcers Gain Clout on Street,* WALL ST. J., June 21, 2002, at C1.

163. *See* Gasparino, *Cleaning Up Wall Street, supra* note 153.

164. *See* Russell Gold & Andrew Caffrey, *United Crime Busters,* WALL ST. J., Aug. 1, 2002, at B1.

165. *See* Craig, *supra* note 162.

166. *New Cops on the Beat,* INSTITUTIONAL INVESTOR, July 2002, at 77, 78. It appears that the SEC did not cooperate with the New York Attorney General's investigation. *See* Michael Schroeder, *SEC Welcomes Prosecutions,* WALL ST. J., June 11, 2002, at A2.

167. Sarbanes-Oxley Act of 2002 § 501, 15 U.S.C. § 78o-6 (adding § 15D to the Exchange Act).

168. *See* Matt Fleisher-Black, *Spitzer Faces Hurdle Over Merrill Deal,* N.Y. L.J., July 22, 2002, at 1; Gold & Caffey, *supra* note 164.

cal and philosophical. It may also become a matter of law for the courts to address. Under the payment for order flow cases, it would not be difficult to find conflict or even field preemption if SEC or SRO rulemaking results in regulations that take a different approach from the settlement made between Merrill Lynch and the New York Attorney General. But the payment for order flow cases were private actions for damages. A court might be reluctant to apply this analysis to prosecutions by a state attorney general. Further, if the conflict that arises is between regulatory action by a state official and a rule of an SRO, is the conflict a federal constitutional conflict? Can an SRO rule trump state law in all cases where the regulation was mandated by a federal statute and approved by the SEC?[169]

In addition, where a state action brought either by a prosecutor or a private plaintiff is instituted as a broad statutory or common law antifraud claim, it is difficult to find preemption unless the SEC has acted by adopting detailed regulations as it did with respect to payments for order flow. In *Zuri-Invest AG v. NatWest Finance, Inc.* a federal district court held that a state fraud action was not preempted by the federal securities laws, including the NSMIA.[170] Rather, the primary purpose of the NSMIA was to preempt state blue-sky laws regulating the registration and underwriting of securities. It did not preclude states from regulating fraudulent conduct or extinguish state

169. It may be relevant to note that all SEC registered broker-dealers are required by federal law to join the NASD. Securities Exchange Act of 1934 § 15(a), 15 U.S.C. § 78o(a) (2000). *See also* Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1573, 1574 n.19 (9th Cir. 1990). Further, the NASD was created pursuant to federal authorization in 1938. The Maloney Act of 1938, Pub. L. No. 719, 52 Stat. 1070 (codified at 15 U.S.C. § 78o-3 (2000)) (adding § 15A to the Exchange Act of 1934). In a pending case, SROs are seeking to invalidate disclosure rules of the Judicial Council of California that conflict with rules for SRO arbitrators. *See NYSE Sue to Block California Rules in Securities Arbitrations; Preemption Cited,* 34 Sec. Reg. & L. Rep. (BNA) No. 31, at 1296 (Aug. 5, 2002).

170. 177 F. Supp. 2d 189 (S.D.N.Y. 2001). *See also* IDS Bond Fund, Inc. v. Gleacher NatWest Corp., 2002 WL 373455 (D. Minn. Mar. 6, 2002); Gabriel Capital, L.P. v. NatWest Finance, Inc., 122 F. Supp. 2d 407 (S.D.N.Y. 2000); Gabriel Capital, L.P. v. NatWest Finance, Inc., 94 F. Supp. 2d 491 (S.D.N.Y. 2000). *But see* Myers v. Merrill Lynch, 1999 WL 696082, at *8–10 (N.D. Cal. Aug. 23, 1999), *aff'd*, 249 F.3d 1087 (9th Cir. 2001).

claims based on fraud.[171] Similar issues have arisen under the SLUSA.[172]

III. FRAMEWORK AND HISTORICAL DEVELOPMENT OF SECURITIES LAW IN THE EU

A. Sources of Law

The EU is not a national federal system, but rather a federation by treaty of member nations for limited purposes. The EU aspires to reach certain goals expressed in the various treaties that serve as the legal foundation for the EU[173] through legal actions initiated by the European Commission ("Commission"), which may take the form of directives or regulations.[174] Such

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171. *See also* H.R. REP. NO. 104-622 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3896 ("Committee's intention not to alter . . . State statutory or common law with respect to fraud or deceit . . . .").

172. *See* Green v. Ameritrade, Inc., 279 F.3d 590 (8th Cir. 2002) (state contract claim not preempted by SLUSA).

173. *See* TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Nov. 10, 1997, O.J. (C 340) 3 (1997), arts. 9, 99, 105, 108 (as in effect 1957) (now arts. 46, 103, 105, 107) [hereinafter EC TREATY]. The Treaty on European Union significantly amended the earlier treaties and set forth the framework for monetary and fiscal union and the establishment of the European Central Bank. TEU OR MAASTRICHT TREATY: TREATY ON EUROPEAN UNION (EU), Feb. 7, 1992, 1992 O.J. (C 191) 1, 31 I.L.M. 253.

The founding treaties leading to the establishment of EU include: ESCS or PARIS TREATY: TREATY ESTABLISHING THE EUROPEAN COAL AND STEEL COMMUNITY, Apr. 18, 1951, 261 U.N.T.S. 140; EEC or TREATY OF ROME: TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY, Mar. 25, 1957, 298 U.N.T.S. 3; EAEC or EURATOM Treaty: TREATY ESTABLISHING THE EUROPEAN ATOMIC ENERGY COMMUNITY, Mar. 25, 1957, 298 U.N.T.S. 167; MERGER TREATY: TREATY ESTABLISHING A SINGLE COUNCIL AND A SINGLE COMMISSION OF THE EUROPEAN COMMUNITIES, Apr. 8, 1965, 1967 J.O. 152/1 (in French); SEA: SINGLE EUROPEAN ACT, Feb. 17, 1986, 1987 O.J. (L 169) 1, 25 I.L.M. 506 (an act modifying the basic treaties); TEU OR MAASTRICHT TREATY: TREATY ON EUROPEAN UNION (EU), Feb. 7, 1992, 1992 O.J. (C 191) 1, 31 I.L.M. 253; TREATY OF AMSTERDAM AMENDING THE TREATY ON EUROPEAN UNION, THE TREATIES ESTABLISHING THE EUROPEAN COMMUNITIES AND CERTAIN RELATED ACTS, Oct. 2, 1997, O.J. (C 340) 1 (1997).

174. The European Commission is composed of twenty Commissioners, two from each of the five largest member states, and one from each of the smaller states, appointed by their respective national governments. EC TREATY, art. 157. Since directives are given legal effect only through national laws, rights and duties are not conferred on individuals by a directive. *Id.* art. 189. Sometimes, however, a member state will be held liable for its failure to timely adopt a directive. *Id.* art. 171. *See* Case 9/70, Franz Grad v. Finanzamt

legislation is then sent to the European Parliament[175] and adopted by the Council of Ministers.[176] Directives are not generally self operating but must be implemented through the national laws of the various member states, whereas regulations are directly applicable throughout the EU. In addition, the provisions of the treaties which govern the EU directly apply to the member states. The EU does not have any treaty provision comparable to the Supremacy Clause, so preemption of national law is not possible, but federal enforcement mechanisms do exist.

The Commission can, at the request of a member state, bring an action against another member for failing to adopt a law implementing a directive, or for having legislation that is contrary to a directive, regulation or treaty provision. Also, the European Court of Justice may strike down a national law as contrary to a treaty provision in a case instituted by the Commission or by one member state against another.[177] Although the EU does have some administrative bodies, with the exception of the European Central Bank, these agencies do not have regulatory powers comparable to U.S. federal agencies such as the SEC.[178]

The primary thrust of the European Economic Community Treaty ("EEC Treaty") was to create a single European economic market, primarily through harmonization and mutual recognition of national laws providing for the free movement of goods, services, people and capital. The Treaty of the European Union ("TEU") further advanced economic integration through

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Traustein, [1970] E.C.R. 825. The direct applicability of regulations is based on Article 249 of the EC Treaty.

175. The TEU changed the power of Parliament with respect to legislation from purely advisory to one of cooperation and co-decision. *See* EC TREATY, *supra* note 173, arts. 249, 251, 252 (as in effect 1957) (now arts. 189, 189b, 189c). Members of the European Parliament are directly elected by the peoples of Europe. *Id*. art. 190 (now art. 138).

176. The Council of Ministers is composed of one national representative from each member state and has the capacity to enact EU legislation and is the principal decision making body of the Union. *Id*. arts. 202, 203 (now arts. 145, 146).

177. *Id*. arts. 226, 227 (now arts. 169, 170). *See also* Case C-483/99, Re Golden Shares: Commission v. French Republic, 2 C.M.L.R. 49 (2002).

178. *See* Andrea M. Corcoran & Terry L. Hart, *The Regulation of Cross Border Financial Services in the EU Internal Market*, 8 COLUM. J. EUR. L. 221, 232–33 (2002).

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the establishment of a common European currency and central bank and moved beyond economic union with the introduction of the concept of European citizenship, but then retreated from federalism by adopting the principle of subsidiarity.[179] It has been argued that this was a political reaction against the use of mutual recognition as a smoke screen for deregulation at a national level.[180] The subsidiarity principle requires EU action to be taken only where the objectives of the treaties cannot be adequately achieved at a national level and can be better achieved by EU action. However, these tests apply only when the EU acts outside its exclusive competence. This attempt at allocating power between member states and the EU has not resolved the ambiguities of shared legal power.[181]

B. Incomplete Harmonization of Securities Regulation

The Treaty of Rome, which laid the foundation for the European Economic Communities ("EEC") in 1957, was designed to remove all restrictions on the free movement of goods, persons, services and capital within the EU.[182] This plan was furthered by the EC White Paper of 1985, which set forth a program for creating a single European market by 1992. The single market was envisioned as expansive and flexible in order to ensure that resources, including capital and investment, would flow into the areas of greatest economic advantage.[183] National regulators would continue to play a supervisory role, but financial services would be liberalized by putting into effect EU-wide minimum standards that would supersede former national regulations.[184] A timetable for the adoption of securities law directives was included in the White Paper.[185] The White Paper was then implemented by the Single European Act amendments to the Treaty of Rome, which encouraged and facilitated the use of

179. EC TREATY, *supra* note 173, arts. 4, 5, 8, at 17–22.

180. *See* Imelda Maher, *Legislative Review by the EC Commission, in* NEW LEGAL DYNAMICS OF EUROPEAN UNION 235, 236 (Jo Shaw & Gillian Moore eds., 1995).

181. *Id.* at 237.

182. EC TREATY, *supra* note 173.

183. Commission of the European Communities, Completing the Internal Market: White Paper from the Commission to the European Council, COM(83)310 final at 8 [hereinafter White Paper].

184. *Id.* at 103.

185. *Id.* Annex, at 26–27.

directives to harmonize the laws of Member States.[186] The TEU or Maastrict Treaty which came into effect in 1993 then provided for an economic and monetary union including a common currency.[187] The objective of these efforts was to remove technical barriers, which either added costs or restricted entry into particular markets, thereby impeding the free movement of goods, services, persons and capital.

The Commission recognized that abolition of anticompetitive practices was not sufficient to create a common financial market. There was a need for EU-wide rules to underpin the stability of the financial system and to provide a satisfactory level of protection for consumers. The mechanism chosen for integration of the financial markets was a series of directives to harmonize essential standards throughout the EU and to enable financial regulators to practice home country control, but oblige them to honor principles of mutual recognition. Four groups of financial law directives were adopted relating to the efforts to develop a single securities market in the EU. These were directives on financial disclosure, directives covering public securities offerings and stock exchange listings, directives regulating trading markets, and directives regulating financial intermediaries.

As a result of these directives, securities regulation has been partially but incompletely harmonized. There still is not an integrated European capital market enabling issuers to float public offerings or savers to invest and trade across national borders in a single market.[188] The author previously advocated the creation of a European Securities Commission to achieve the integration of European capital markets comparable to the integration of European monetary markets that was achieved by the creation of the euro and the European Central Bank.[189] Other commentators have similarly argued in favor of a Euro-

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186. Single European Act, 1987 O.J. (L 169) 1, 25 I.L.M. 503 (1987).

187. TEU, 1992 O.J. (C 224) 1, 31 I.L.M. 247 (1992).

188. Financial Services: Implementing the Framework For Financial Markets: Action Plan, COM(99)232 final at 6 [hereinafter Financial Services Action Plan].

189. *See* Roberta S. Karmel, *The Case for a European Securities Commission,* 38 COLUM. J. TRANSNAT'L L. 9 (1992).

pean Securities Commission,[190] while some others have either opposed the idea, or argued that the time is not ripe for such a development.[191]

There is a serious question as to whether a European Securities Commission could be organized under existing treaty provisions. Although power to create such a Commission could be impliedly found in the existing provisions, an amendment to the TEU probably would be necessary.[192] The establishment of the European Central Bank required an amendment to the EC treaty, and since there has been strenuous objection from the British to a European Securities Commission, it is unlikely that a well constructed securities commission could be established without a treaty amendment.[193]

As a result of the adoption of several capital markets directives, especially the Investment Services Directive ("ISD")[194] and the Insider Dealing Directive,[195] and in response to marketplace and political developments, new national government securities regulators were created in some European countries that previously lacked such regulators.[196] Other national regu-

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190. *See* Gilles Thieffry, *The Case for a European Securities Commission*, *in* REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY 211, 231 (Eilís Ferran & Charles A.E. Goodhart eds., 2001).

191. *See* Karel Lannoo, *Does Europe Need an SEC? Securities Market Regulation in the EU* (1996), *available at* www.ecmi.com (last visited Mar. 20, 2003); BENN STEIL & ERICK BERGLOF, THE EUROPEAN EQUITY MARKETS: THE STATE OF THE UNION AND AN AGENDA FOR THE MILLENNIUM 136 (1996); Andrew Whittaker, *A European Law for Regulated Markets? Some Personal Views*, *in* EUROPEAN SECURITIES MARKETS, THE INVESTMENT SERVICES DIRECTIVE AND BEYOND 269, 273 (Guido Ferrarini ed., 1998). *See also* Eddy Wymeersch, *Regulating European Markets: The Harmonization of Securities Regulation in Europe in the New Trading Environment, in* REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY 189, 192–93.

192. *See* Thieffry, *supra* note 190, at 222–23; Eddy Wymeersch, *From Harmonization to Integration in the European Securities Markets,* 3 J. CORP. L. & SEC. REG. 1 (1981).

193. *See* Thieffry *supra* note 190, at n.41.

194. Council Directive 93/22 of 10 May 1993 on Investment in Services in the Securities Field, 1993 O.J. (L 141) 27, as amended by corrigendums to 93/22, 1993 O.J. (L 170) 32, 1993 O.J. (L 194) 27.

195. Council Directive No. 89/592, 1989 O.J. (L 334) 30.

196. *See* Stephen J. Leacock, *In Search of a Giant Leap: Curtailing Insider Trading in International Securities Markets By the Reform of Insider Trading Laws Under European Council Directive 89/592*, 3 TULSA J. COMP. & INT'L L. 51, 55 (1995). Germany did not have a federal securities regulator until it was required to do so to implement the Insider Dealing Directive. *Id.* at 62–63.

lators were reformed and securities regulation became more centralized.[197] National regulators can be a force for further harmonization, but to some extent their interests diverge, because established national securities commissions do not wish to cede power to one another or to a federal securities commission.

Although securities regulation in Europe has generally improved since the White Paper and Single European Act 1992 deadline, dissatisfaction with the pace of capital markets integration in Europe led to the Financial Services Act Plan[198] in 1999 and the Lamfalussy Report[199] in 2001. The Financial Services Action Plan, which was two years in the making, was an aspirational program by the European Commission for more rapid progress toward a single financial market.[200] It was prompted by a sense that despite the introduction of the euro, the capital markets in Europe had remained fragmented. It set forth as strategic objectives the development of a single EU wholesale market where, among other things, capital could be raised on an EU-wide basis and EU companies would produce a single set of financial statements, open and secure retail markets, and state of the art prudential rules and supervision.[201]

The Commission recognized that an overhaul of the way the EU developed financial services legislation was needed to

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The Netherlands established the Netherlands Authority for the Financial Markets on March 1, 2002 to oversee the entire financial market sector. *See News: STE becomes Authority for the Financial Markets* (Feb. 28, 2002), *at* http://www.autoriteit-fm.nl/.

197. On December 1, 2001, the U.K.'s Financial Services Authority became a single regulator through the Financial Services and Markets Act 2000. *See* Financial Services Authority, *at* http://www.fsa.gov.uk/ (last modified Sept. 5, 2002). On July 2, 1996 France's Commission des Opérations de Bourse was given wider powers (sanctioning ability, etc.). *See* Commission des Opérations de Bourse, *at* http://www.cob.fr/cobgb/. Germany's Bundesanstalt für Finanzdienstleistungsaufsicht (BAFin) took over the function of the earlier BAWe on May 1, 2002 and has much more regulatory power than before. *See* BAFin, *at* http://www.bawe.de/english/index_re_e.htm (last visited Feb. 21, 2003).

198. Financial Services Action Plan, *supra* note 188.

199. THE COMMITTEE OF WISE MEN, FINAL REPORT OF THE COMMITTEE OF WISE MEN ON THE REGULATION OF EUROPEAN SECURITIES MARKETS (2001), *available at* http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussyen.pdf. [hereinafter LAMFALUSSY REPORT].

200. Financial Services Action Plan, *supra* note 188, at 3–4.

201. *Id.* at 22–28.

achieve these goals. A European Securities Commission was not recommended but other mechanisms were suggested to avoid piecemeal and reactive protracted decision-making and the inflexibility of regulation by directives.[202] One suggestion was a high level forum to consult with affected interest groups and to forge a consensus between national financial regulators on emerging challenges.[203] Another suggestion was acceleration of co-decision procedures of the European Parliament.[204] Implementation of these suggestions would impinge on the Commission's legal right of initiative and the European Parliament's hard-won right of the co-decision, and the latter proved politically troublesome.

In response to the Financial Services Action Plan, the EcoFin Council appointed a Committee of Wise Men under the Chairmanship of Baron Alexandre Lamfalussy, which issued its final report on February 15, 2001.[205] The Report sets forth the benefits of capital market integration, a long litany of areas in which necessary European rules governing the capital markets are needed, and reasons why the regulatory process is too slow, too rigid, produces ambiguous regulations, and fails to distinguish between core principles and day-to-day implementing rules.[206] Blame was assigned to the legislative process itself, especially co-decision procedures and subsidiarity principles.[207] The Lamfalussy Report did not recommend the creation of a European Securities Commission, but rather the establishment of two new committees — an EU Securities Committee, with high level members appointed by EU member states, and an EU Securities Regulators Committee, composed of the heads of member state securities regulators. The Lamfalussy Report took a four-tiered approach to regulatory reform:[208] (1) framework principles would continue to be decided by normal EU legislative procedures; (2) the two new Committees would assist the Commission in implementing the framework principles; (3) enhanced cooperation and networking among EU securities regulators

202. *Id.* at 16.
203. *Id.* at 16–17.
204. *Id.* at 17–18.
205. LAMFALUSSY REPORT, *supra* note 199, at 189.
206. *Id.* at 9–15.
207. *Id.* at 13–14.
208. *Id.* at 19, 30–33.

would lead to common implementing standards; and (4) the European Commission would be prodded to engage in strengthened enforcement of community law.[209] The Lamfalussy Report also recommended a greater use of regulations rather than directives.[210]

Although the Lamfalussy Report was welcomed by the financial community, it was not so well received by the European Parliament, which feared its co-equal legislative powers would be undermined. After a delay of almost a year, however, the European Parliament agreed to have a lesser say on secondary securities legislation and the EU Securities Committee came into existence.[211] In addition, the Committee of European Securities Regulators ("CESR") was constituted as a successor to the Federation of European Securities Commissions ("FESCO").[212]

A report by the European Commission was issued in June 2002 at the half-way stage of the implementation timetable for the Financial Services Action Plan.[213] Although of the forty-two original measures in the plan twenty-six have been completed, important initiatives, such as updating the regular reporting requirement for raising capital on an EU wide basis, amending the ISD, and a directive on takeover bids, have not been achieved.[214] Regulation accomplished, however, one very important achievement. As of 2005, all listed EU companies will be required to report their financial results according to international accounting standards.[215]

It remains to be seen whether harmonization of securities laws and regulations and integration of the European capital markets will be accomplished by way of the fast track procedures recommended in the Lamfalussy Report. Also, it is diffi-

209. *Id.* at 19.

210. *Id.* at 26.

211. *See generally* Karel Lannoo & Mattias Levin, *Securities Market Legislative Procedures in the EU* (CEPS) (on file with author). *See also* Commission of the European Communities, Commission Decision Establishing the European Securities Committee, COM(2001)1493 final.

212. *See* Commission of the European Communities, Commission Decision Establishing the Committee of European Securities Regulators, COM(2001)1501 final. *See also* Corcoran & Hart, *supra* note 178, at 281–82.

213. European Commission, Financial Services: An Improving Climate — But Quite Some Way to Go, COM(02)267 at 2, *available at* http://europa.eu.int/comm/internal_market/en/finances/actionplan/index.htm.

214. *Id.* at 10.

215. *Id.* at 4.

cult to predict how the current world wide stock market turmoil will impact both U.S. and EU securities regulation. As the Lamfalussy Report itself pointed out, a failure of its recommended approach could lead to a treaty amendment creating a single EU regulatory authority for financial services.[216]

IV. TAKEOVER REGULATION

A. Impasse in the U.S.

A conflict between federal and state interests with respect to securities regulation arises when there is a tender offer to purchase the shares of a target corporation. This collision of law may also be described as a conflict between securities law and corporation law. In a tender offer for cash (or notes),[217] the shareholders of the target company are deprived of any going forward interest in the profits of the target company; and their rights as shareholders cease. If the tender offer is for securities of the bidder, or results in a merger with the bidder, then the shareholders of the target company become the shareholders of a larger combined enterprise. In either event, the tender offer is an urgent, material transaction affecting the very existence of the target company.[218] Further, although shareholders generally benefit economically from a takeover because they enjoy a premium for control, other corporate constituencies, particularly management and labor, are likely to be disadvantaged by a takeover.[219]

In 1968, the U.S. Congress passed the Williams Act regulating takeovers, adding Sections 13(d) and 14(e) to the Exchange Act.[220] Although a stated purpose of the Williams Act was to maintain neutrality between the bidder and target in a tender offer contest,[221] the statute was intended to protect investors

216. Thieffry, *supra* note 190, at 233.

217. In the U.S., takeovers generally are for cash; in the U.K., due to tax implications, they are generally for notes. This difference leads to a conflict between U.S. and U.K. law concerning takeovers. *See* Cross-Border Tender Offers, Business Combinations and Rights Offerings, Securities Act Release No. 33-7611, 63 Fed. Reg. 69,136, n.41 (Dec. 15, 1998)

218. *See* Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

219. Bondholders may also be disadvantaged. *See* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 906 F.2d 884 (2d Cir. 1990).

220. *See supra* note 37.

221. *See* CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987).

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confronted by a takeover bid. It accomplished this objective by requiring certain disclosure by the bidder concerning a tender offer and regulating the manner in which a tender offer is conducted.[222] Very generally, many commentators and the SEC were persuaded that takeovers were not only good for shareholders, but also that control contests were a check on management, which weeded out corporate leaders who were not effective.[223]

Managements threatened by hostile takeovers developed a variety of defense mechanisms, including poison pills, selling the crown jewels, staggered boards, control clauses, and golden parachutes. These mechanisms were generally upheld under state corporate law as appropriate unless a corporation was in effect put up for sale by management.[224] Efforts to invalidate anti-takeover mechanisms through suits in the federal courts under the Williams Act failed because the U.S. Supreme Court viewed these defenses as matters of internal corporate management covered by state corporate law so long as full disclosure was made.[225] Although the SEC was able to adopt rules under the Williams Act to prohibit some of the defenses permitted by state corporate law,[226] when the SEC attempted to outlaw the potent anti-takeover device of lesser voting shares for public stockholders, the D.C. Circuit Court struck down the SEC's rule as being beyond its statutory authority.[227]

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222. *See* Regulation of Takeovers and Security Holder Communications, Securities Act Release No. 33-7760, 70 S.E.C. Docket 2229 (Oct. 22, 1999).

223. *See, e.g.,* Lucian Arye Bebchuk & Allan Ferrell, *A New Approach to Takeover Law and Regulatory Competition,* 87 VA. L. REV. 111, 159 (2001); Lucian A. Bebchuk, *The Case for Facilitating Tender Offers,* 95 HARV. L. REV. 1028 (1982); William J. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties,* A.B.F. RES. J. 341, 347–52 (1983); Frank Easterbrook & Daniel Fischel, *The Proper Role for a Target's Management in Responding to a Tender Offer,* 94 HARV. L. REV. 1161 (1981); Roberta Romano, *The Political Economy of Takeover Statutes,* 73 VA. L. REV. 111 (1987).

224. *See* Paramount Comm. Inc. v. Times Inc., 571 A.2d 1140 (Del. 1990); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Moran v. Household Int'l. Inc., 500 A.2d 1346 (Del. 1985); Revlon Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173 (Del. 1986).

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

226. *See, e.g.,* All Holders and Best Price Rules, 17 C.F.R. § 240.14d-10 (1987) (upheld in Polaroid Corp. v. Disney, 862 F.2d 987 (3d Cir. 1988)).

227. Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990).

In addition to the conflicts between the Williams Act and state corporate law that were fought out in state and federal courts, management and labor groups were able to persuade state legislatures to pass anti-takeover statutes. Early statutes either unduly delayed the takeover process or permitted state blue-sky commissioners to conclude that takeovers were unfair. Such a statute was struck down by the U.S. Supreme Court as unconstitutional.[228] Later state statutes, which imposed delays in the tender offer process, prohibited control share merger transactions for a period of years, or endorsed the consideration by corporate managers of non-shareholder constituencies in control contests, were upheld by the federal courts.[229]

The refusal of the federal courts to invalidate most state anti-takeover legislation, or to endorse SEC efforts to curb takeover defenses, left the task of articulating how management should behave in control contests to the state courts. Because a majority of U.S. public corporations are incorporated in Delaware, decisions by the Delaware state courts became determinative of how the relevant law developed.[230] The only national standard applicable to contests for corporate control other than the disclosure and specific procedural provisions of the Williams Act are stock exchange listing standards, which have an ambiguous legal footing. Although they originated in state contract laws, they are SRO "rules" under the Exchange Act, subject to SEC review and approval.[231]

Most academics have criticized the impasse that developed between federal and state law with regard to takeovers, believing that takeovers are important mechanisms for protecting shareholders and disciplining corporate managers.[232] But the Main Street interests that question the wisdom of encouraging hostile takeovers are probably at least as powerful as the Wall

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228. Edgar v. Mite Corp., 457 U.S. 624 (1982).

229. *See* CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987); Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496 (7th Cir.), *cert. denied,* 493 U.S. 955 (1989). *See* Roberta S. Karmel, *The Duty of Directors to Non-Shareholder Constituencies in Control Transactions*, 25 WAKE FOREST L. REV. 61, 66–70 (1990).

230. *See* Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 339 (1998).

231. *See* ABA, *Market Structure Report*, *supra* note 4, at 1516–27.

232. *See* Edward B. Rock, *America's Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L.Q. 367, 375–78 (1996).

Street interests favoring hostile takeovers. Therefore it is unlikely that state anti-takeover statutes or state corporate law giving corporate management considerable leeway in responding to takeover bids will be overturned, unless economic developments create a new consensus with respect to contests for corporate control.[233]

B. Impasse in Europe

Like the U.S., the EU has thus far been unable to reconcile the political and legal interests that clash in the takeover arena. On July 4, 2001, a twelve year effort by the European Commission to adopt an EU Takeover Directive failed by a tie vote of 273-273 in the European Parliament.[234] This was a serious set-back for economic liberalization and integration of the European capital markets. The Takeover Directive was mired in politics from its inception and its various iterations and final defeat over the past decade illustrate the problems of developing a single European capital market.

In the U.K., management of corporations works primarily for the benefit of shareholders; whereas, on the continent, management and directors owe equal loyalty to shareholder claims and those of creditors and labor. This fact accounts for the key differences in business environments for hostile takeovers in the U.K. and on the continent, and resulted in impediments to the adoption of the Takeover Directive.[235] Hostile takeovers are common in London and are regulated by the Panel on Takeovers and Mergers, a self-regulatory body that operates pursuant to the City Code on Takeover and Mergers ("City Code"). The two most important principles in the City Code are that the shareholders of an offeree company must decide whether or not an offer should succeed, and that all equity holders must be treated equally. In addition, after an offer is communicated to the board, or even when a board has reason to believe an offer is imminent, the offeree board is prohibited from taking any action without the approval of shareholders at a general meeting "which could effectively result in any bona fide offer being frus-

233. *See* Pinto, *supra* note 230, at n.59.
234. *See Pull up the Drawbridge,* ECONOMIST, July 7, 2001, at 67.
235. *See* Ingrid Depser, *Amended EC Proposal for a 13th Council Directive on Company Law Concerning Takeovers and Other General Bids*, 19 INT'L BUS. LAW. 483, 484 (1991).

trated or in the shareholders being denied an opportunity to decide on its merits."[236] The initial draft of the Thirteenth Directive on Company Law, patterned after the City Code to some extent, was concerned with the equal treatment of the parties involved in takeovers and the transparency of corporate takeovers while a takeover bid was in progress.[237]

Since capital formation depends upon equity capital in the U.K. there is a constant monitoring of management performance, protection of minority shareholders, and efficient resource allocation. In contrast, in Germany and in other continental states, management is given a long-term mandate, and its first duty is to the business and then to the employees and the company's bankers. Further, in Germany there is stable and knowledgeable business ownership with close ties to banks. Given this difference, the British regarded takeovers as the ultimate discipline over bad management, whereas the Germans considered hostile bids as inimical to the three ingredients of their post-war success — management's ability to take a long-term view, harmonious labor relations, and the disciplinary function of German banks. Accordingly, German law countenanced numerous barriers to hostile takeovers.[238] The Germans and other continentals opposed the Thirteenth Directive, because they believed it adopted the pro-takeover underpinnings of the U.K. system. The British also opposed it, because they did not wish to see their self-regulatory system be replaced by a statutory system.

However, the Commission insisted that there was a need to facilitate the restructuring of European companies to meet international competition, so an amended version of the Thirteenth Directive was put forth.[239] By this time, takeover activity had increased somewhat and the need for shareholder pro-

236. PANEL ON TAKEOVER AND MERGERS, THE CITY CODE ON TAKEOVERS AND MERGERS AND THE RULES GOVERNING SUBSTANTIAL ACQUISITIONS OF SHARES 7 (3d ed. 1990).

237. Proposal for a Thirteenth Council Directive on Company Law Concerning Takeover and Other General Bids, 1989 O.J. (C 64) 8. There was a provision for a mandatory bid once a threshold position of one-third of the voting shares was acquired. Also, controlling target-company shareholders would have been required to act in the interests of all shareholders by not frustrating the bid.

238. *See* Depser, *supra* note 235, at 484.

239. 1990 O.J. (C 240) 9.

tection had become more apparent.[240] The amended Thirteenth Directive required each Member State to designate a supervisory authority to put it into effect, a requirement that previously had been included in the EU Insider Trading Directive.[241] There was also provision for mutual recognition.[242] The amended Thirteenth Directive fared no better, however, in achieving acceptance and a consensus in favor of adopting it, than the original proposed directive. In 1997, a new and streamlined proposal for a takeover directive was put forward by the Commission.[243] This proposal took into account the subsidiarity principle and left member states some latitude in deciding how to achieve the goals of the directive. The directive would have applied to a company's securities traded on a regulated market governed by the law of an EU member state. Nevertheless, the general principles of the amended Thirteenth Directive that would have been followed in national law were unchanged.[244]

240. *See* Lois Moore, *The EC's Proposed Takeover Directives*, N.Y. L.J., May 28, 1991, at 1.

241. The supervisory authorities were then given the mandate to assure, among other things, that holders of securities in the target company would be treated equally; target company shareholders would have time and information to reach an informed decision on the bid and the target company board would not frustrate the bid. Mandatory bid provisions and mandated disclosure in offering documents also were specified. *See* Amended Commission Proposal for a Thirteenth Council Directive on Company law Concerning Takeover and Other General Bids, art. 6, 1989 O.J. (C 240) 7, 15.

242. *See id*. art. 6(3).

243. *See* Amended Commission Proposal for a Thirteenth European Parliament and Council Directive on Company Law Concerning Takeover Bids, 1997 O.J. (C 378) 10.

244. The general principles were: (1) holders of securities in target companies who are in the same position must be treated equally; (2) the addressees of a bid must have sufficient time and information to enable them to reach a properly informed decision; (3) the board of an offeree company must act in the interests of the company as a whole; (4) false markets must not be created in the securities of companies involved in a bid; and (5) target companies must not be hindered in the conduct of their business beyond a reasonable time. *See* Amended Commission Proposal for a Thirteenth Council Directive, art. 5, 1997 O.J. (C 378) 15. Further, the establishment of national rules would have been necessary in order to make public a decision to bid once the supervisory authority and target company were notified and the bidder would have been required to draft a disclosure document and submit it to the supervisory authority. *Id*. art. 6, at 16–17. The Directive recognized that prompt announcement of an intention to launch a takeover bid reduces opportunities for

The twice amended directive remained an anathema to the British, who feared that, despite the recognition of the Takeover Panel as a proper supervisory authority, it would change the workings of the Panel by tangling its operations in endless legal challenges.[245] When the British finally agreed to support it, the Directive became mired in a spat between Britain and Spain over Gibraltar. In the meantime, pressure in Europe grew to harmonize an array of takeover laws that had been adopted in the major European economies and had provisions that differed widely. Some were based on shareholder protection principles. Others were more friendly to target managements by permitting defense mechanisms.[246] Then, in April 2001, just as the Council and the European Parliament were on the verge of reaching an agreement to reconcile their differences over the Takeover Directive, Germany withdrew its support for the measure because of its concerns that U.S. companies would prey on German companies.[247] Until this time, all fifteen EU member states had agreed that company boards would be required to get shareholder approval before adopting poison pills, but Germany wanted to water down this provision and let management decide on poison pills.[248] It was pressure from German companies, which, following the hostile takeover of Mannesmannröhren-Werke AG by Vodafone, feared takeovers of companies such as Volkswagen, that ultimately defeated the Takeover Directive in the European Parliament, where a tie vote constitutes a veto, since a majority vote is required to approve a directive.

insider trading. *Id.* art. 7, at 17. The target company board would have been prohibited from taking action to affect the success of the bid after receiving notification of the bid. *Id.* art. 8, at 17–18. Rules would have had to have been published on withdrawal or nullity of bids, revision of bids, treatment of competing bids, and disclosure of the outcome. *Id*. art. 9, at 18. Whether mandatory bids would have been required at any point was left to the laws of the Member States. *Id.* art. 10, at 18.

245. *See More Talks on Defining Takeover Bids Directive*, EUR. REP., Jan. 19, 1999, *available at* 1999 WL 8305668; *Euro-Takeovers*, FIN. TIMES, Jan. 14, 1997, at 17.

246. *See* Anita Raghavan & Thomas Kamm, *Pressure Grows to Unify Europe's Takeover Laws,* WALL ST. J., Dec. 13, 1999, at A28.

247. *See EU Expects Corporate Takeover Directive To Pass Despite Loss of German Backing,* 33 Sec. Reg. & L. Rep. (BNA) No. 31, at 683 (May 7, 2001).

248. *See* Paul Meller, *Europe Plan on Mergers Hits a Snag,* N.Y. TIMES, May 3, 2001, at W1.

This was not the end of the story, however. A week after the defeat of the Takeover Directive, the German government approved a draft takeover law intended to provide options for target companies to defend against hostile takeovers, and stated that it intended to continue pushing for an EU directive on takeovers.[249] After several drafts were presented, a new German Takeover Act, offering legal rules generally in line with international standards and providing for effective enforcement, became effective on January 1, 2002.[250] As a result, German managements are now more limited in adopting defensive measures to unwelcome takeovers, but they will continue to have more latitude in erecting barriers to takeovers than managements of U.K. companies.[251]

In addition, the Commission continued to push for an EU-wide takeover regime. It acted on two fronts. First, it set up a High Level Group of Company Law Experts ("High Level Group") to provide advice on issues related to pan-European rules for takeover bids.[252] Second, it successfully prosecuted a case invalidating France's golden share in Société National Elf-Aquitaine.[253] These two developments have laid the foundation for a new EU Takeover Directive which may eventually be adopted.

The High Level Group determined that takeover bids are basically beneficial. It endorsed a level playing field for takeovers, that is, takeover bids should be undertaken with a similar expectation of success across the EU, and shareholders should in all member states have corresponding opportunities to tender their shares.[254] The High Level Group set forth two principles for achieving a level playing field. First, in the event of a take-

249. *See Cabinet Adopts Draft Takeover Law Meant to Protect Target Companies*, 7 World Sec. L. Rep. (BNA) No. 31, at 5 (July 2001).

250. *See* Hans-Michael Giesen, *The New German Public Takeover Law,* 31 INT'L L. NEWS 1, 23 (2002).

251. *Id.* at 22.

252. *See* EUROPEAN COMMISSION, REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTISE ON ISSUES RELATED TO TAKEOVER BIDS (Jan. 10, 2002), *available at* http://europa.eu.int/comm/internal_market/en/company/company/news/hlg01-2002.pdf. [hereinafter REPORT OF THE HIGH LEVEL GROUP].

253. *See* Case C-483/99, Re Golden Shares: Commission v. French Republic, 2 C.M.L.R. 49 (2002).

254. *See* REPORT OF THE HIGH LEVEL GROUP, *supra* note 252, at 2, 18–20.

over bid, the ultimate decision as to tendering shares to a bidder and for what price should rest with the shareholders.[255] Second, shareholders should normally carry control rights in proportion to the risk their shares carry.[256]

The decision of the European Court of Justice, in *Commission v. French Republic*,[257] meshed well with the Report of the High Level Group. In this case, the Court invalidated a critical defense mechanism used by European companies in France and some other states that is commonly called a "golden share." Such a golden share gives the state the power to approve or disapprove any takeover. France argued that any restrictions on the free movement of capital resulting from its golden share in Elf-Aquitaine, a petroleum company, were justified under the principles of necessity and proportionality, because an interruption of supplies of petroleum products could affect public security.[258] The Court disagreed, finding that the golden share was a serious interference with the free movement of capital, went beyond what was needed to prevent the disruption of petroleum supplies, and was therefore in derogation of the EC Treaty.[259] The decision is important because it suggests that other laws preventing takeovers could be similarly invalidated by the court.

The Report of the High Level Group discusses the absence of a level playing field between the U.S. and the EU that would have been created by the failed Thirteenth Directive or a new directive drafted in accordance with the Report. With the adoption of such a directive, European companies would be severely restricted in putting up defenses against takeover bids, while U.S. companies could use a number of devices to defend against

255. *Id.* at 20.

256. *Id.* at 21. To implement this principle, there were two important proposals. First, after the announcement of a takeover bid, the board of the offeree company should only be able to take actions frustrating the bid with the authorization of shareholders at a general meeting. *Id.* at 27. Second, a bidder who has acquired 75% or more of risk-bearing capital should be able to break through any mechanisms held by the target to frustrate the exercise of control by the bidder, including golden shares carrying special control rights held by member states. *Id.* at 30–31.

257. Case C-483/99, Re Golden Shares: Commission v. French Republic, 2 C.M.L.R. 49 (2002).

258. *Id.* ¶¶ 27–30.

259. *Id.* ¶ 51.

a takeover bid.[260] The Report argues that there is no level playing field within the U.S. because of differing state laws, and that the general legal and capital market environment in the U.S. differs widely from the European environment, especially as to transparency and the pressure to enhance shareholder value.[261] Further, the High Level Group suggested that, in adopting takeover legislation, the EU should consider what type of regulation is needed to enhance the development of efficient, integrated capital markets in the EU, rather than what advantages such regulation might give to U.S. companies.[262]

V. THEORIES CONCERNING FEDERALISM

Not all of the overarching theories concerning the value of federalism are relevant to financial regulation or securities regulation in particular. For example, the enhancement of democratic values and the protection of individual liberties[263] are only tangentially, if at all, related to the sometimes competing interests of protecting investors, promoting capital formation, and preventing systemic risk to the financial system, the latter being the primary goals of securities regulation.[264] Although federalism has strong defenders, even in the case of economic regulation,[265] others have argued that national regulation is a better way of reaching public policy goals.[266]

260. REPORT OF THE HIGH LEVEL GROUP, *supra* note 252, at 40.

261. *Id.* at 40–41.

262. *Id.* at 42.

263. *See, e.g.,* Akhil Reed Amar, *Of Sovereignty and Federalism*, 96 YALE L.J. 1425 (1987); William J. Brennan, Jr., *The Bill of Rights and the States: The Revival of State Constitutions as Guardians of Individual Rights*, 61 N.Y.U. L. REV. 535 (1986); William J. Brennan, Jr., *State Constitutions and the Protection of Individual Rights*, 90 HARV. L. REV. 489 (1977); D. Bruce La Pierre, *Political Accountability in the National Political Process — The Alternative to Judicial Review of Federalism Issues*, 80 NW. U. L. REV. 577 (1985); Deborah Jones Merritt, *The Guarantee Clause and State Autonomy: Federalism for a Third Century*, 88 COLUM. L. REV. 1 (1988).

264. *See* SEC, *Who We Are, What We Do*, *at* http://www.sec.gov/about/whatwedo.shtml (last visited Mar. 20, 2003). *See also* Heidi Mandanis Schooner, *Regulating Risk Not Function,* 66 U. CIN. L. REV. 441, 468 (1986).

265. *See, e.g.,* Jonathan R. Macey, *Displacing Delaware: Can the Feds Do a Better Job Than the States in Regulating Takeovers?*, 57 BUS. LAW 1025 (2002); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998). *See also* A.C. Pritchard, *Constitu-*

Much of the academic debate regarding the value of federalism in securities regulation focuses on competition among the states for corporate charters, rather than competition among federal regulators or between federal and state regulators. This literature discusses whether the competition among the states in the corporate law area leads to a race to the bottom, a race to the top or an optimal level of regulation.[267] Further, much of this discussion concerns the specific issue of defenses erected by target companies against hostile takeovers.[268]

When Congress was in the process of preempting state securities regulation in the NSMIA and the SLUSA, critics of the two acts claimed they would diminish investor protection, whereas their supporters argued that they would eliminate duplicative and unnecessary regulation and therefore be efficient and effective.[269] Much of the rhetoric in discussions about the value of

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tional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998, 78 WASH. U. L.Q. 435 (2002).

266. *See, e.g.,* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Edward L. Rubin & Malcolm Feeley, *Federalism: Some Notes on a National Neurosis*, 41 U.C.L.A. L. REV. 903 (1994).

267. This debate was initiated by William Cary, *Federalism and the Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663 (1974), arguing that the competition for corporate charters led to a race to the bottom respecting legal standards. For a response to the effect that such competition leads to a race to the top see Ralph K Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation,* 6 J. LEGAL STUD. 251 (1977). *See also* FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1–40 (1991); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 1–2 (1993).

268. For the most recent debate on these issues see Bebchuk & Ferrell, *supra* note 223; Lucian Ayre Bebchuk & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 BUS. LAW 1047 (2002); Stephen J. Choi and Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law,* 87 VA. L. REV. 961 (2001); Macey, *supra* note 265; Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters,* 69 U. CHI. L. REV. 1103 (2002).

269. *See* Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case for Reallocation of Regulatory Responsibilities*, 78 WASH. U.L.Q. 497 (2000); Manning Gilbert Warren III, *Federalism and Investor Protection: Constitutional Restraints on Preemption of State Remedies For Securities Fraud,* 60. LAW & CONTEMP. PROB. 169 (1997). *See also* Rutheford B. Campbell, *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 WASH. U. L.Q. 407 (2000); David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1, 51 (1998); Richard H. Walker, *Evaluating*

state securities regulation deals with substantive issues of what kind of regulation is appropriate, rather than whether the SEC should be the sole regulator in a particular area or whether there should be dual regulation by the SEC and the states. Discussions of regulatory competition between the SEC and other federal regulators also have more to do with politics than principle.[270]

Some regulatory competition can prevent an agency like the SEC from making serious policy mistakes and give voice to interest groups that are ignored by a single national agency due to so-called "agency capture" by another interest group.[271] Nevertheless, much state securities regulation over the years has been duplicative, unnecessarily burdensome, and expensive for the securities industry, without adding sufficient value in terms of investor protection. Also, state securities regulation is uneven from state to state and even from administration to administration within a particular state.[272] Further, regulatory competition between national regulators frequently is an unseemly jurisdictional battle fueled by politics. Moreover, such

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The Preemption Evidence: Have The Proponents Met Their Burden?, 60 LAW & CONTEMP. PROBS. 237 (1977).

270. An independent commission recommended a single federal regulatory agency for financial market regulation after the 1987 stock market crash. *See* THE BRADY COMMISSION, REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (1988). Similar recommendations were made with regard to banking regulation during the Bush Administration. *See* Kenneth H. Bacon, *White House Alters Plan on Bank Laws,* WALL ST. J., Feb. 5, 1991, at A3. But Congressional oversight committees have never been enthusiastic about such consolidation.

271. *See* John C. Coffee, Jr., *Competition Versus Consolidation: The Significance of Organizational Structure in Financial and Securities Regulation*, 50 BUS. LAW. 447, 454 (1995). *See also* Macey, *supra* note 265, at 1044–46.

272. In some states there are separate securities commissioners; in others the securities commissioner may also be the banking and/or insurance commissioner. *See* North American Securities Administrators Association, NASAA Member Representative List, *at* http://www.nasaa.org/nasaa/abtnasaa/find_regulator.asp (last visited Nov. 14, 2002). The budgets of these commissions vary widely. In New York the Martin Act was rarely enforced for many years except to prosecute local scams. Spitzer, who is a Democrat in a Republican administration and who may be interested in higher office, decided to use the Martin Act against prominent investment banking firms. *See* Editorial, *New York's Bubble Boys*, WALL ST. J., May 22, 2002, at A26; Editorial, *Spitzer's Telecom Meltdown,* WALL ST. J., April 29, 2002, at A18.

competition can lead to disrespect for the law, as one regulator undermines the laws and regulations of another regulator.[273]

The theory that regulatory competition produces the most efficient regulatory structure is based on principles of economics that fail to sufficiently take into account the psychological factors affecting investor confidence. Although the primary goal of securities regulation is frequently articulated as investor protection, this understanding is too simplistic. Capital formation is at the heart of the capitalist system. The reason securities regulation became a matter of federal concern is that there was a need to increase investor confidence in order to generate capital formation in the 1930s. There was also a need to assure against systemic collapses caused by excessive stock market speculation leading to the bursting of the stock market bubble in 1929 and the bankruptcy of numerous financial institutions. State securities regulation and SRO regulation had proved inadequate in performing this task, which was national in scope.

A similar crisis of investor confidence exists today due to the bursting of the technology stock market bubble and the corporate financial scandals of Enron Corp., Worldcom, and other companies.[274] The SEC reacted to this crisis by prosecuting wrongdoers and proposing new regulations on a number of fronts, ranging from a new regulatory system for the accounting profession, certifications of financial statements by CEOs, to certain restrictions on research analysts.[275] Congress then attempted to address this crisis by enacting the Sarbanes-Oxley

273. *See* Coffee, *supra* note 271, at 473 (1995). *See also* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551 (1979); Am. Bankers Ass'n. v. SEC, 804 F.2d 739 (D.C. Cir. 1986).

274. *See* Harold S. Bloomenthal, *Financial Fraud and the New Face of Securities Regulation — Part I*, 24 Sec. & Fed. Corp. L. Rep. (West) 65 (July 2002); Albert A. DeStephano, *Lecture On Corporate Securities & Financial Law: Panel Discussion: Enron: What Went Wrong?,* 8 FORDHAM J. CORP. & FIN. L. 1 (2002).

275. *See Enactment of Broad Accounting, Corporate Governance Reform Act Brings New Prohibitions, Requirements for Executives and Auditors*, 34 Sec. Reg. & L. Rep. (BNA) 1281, 1290–95 (Aug. 5, 2002). *See also* Michael Schroeder, *Deals & Dealmakers: SEC Proposes Rules to Improve Disclosure by Public Companies*, WALL ST. J., May 1, 2002, at C5; Paul Beckett, *SEC Order Forces Executives To Swear by Their Numbers*, WALL ST. J., July 5, 2002, at A1; Michael Schroeder, *Audit-Rules Overhaul Is Proposed in Senate*, WALL ST. J., May 9, 2002, at C11.

Act.[276] The NASAA and the New York Attorney General tried to address these problems by investigating and prosecuting Merrill Lynch and other securities firms.[277]

The issue addressed by this Article is whether problems of this magnitude should be solved by a national regulator, the SEC, or a dual regulatory system of the SEC and state regulators. Since the problems are national, and in some respects international in scope, an effective national regulator seems more appropriate than piecemeal state regulation. On the other hand, aggressive state action, such as the New York Attorney General's action against Merrill Lynch, can highlight gaps and problems with the federal regulatory scheme. But now that Congress has dealt with this issue and ordered the SEC and SROs to find regulatory solutions, should state regulation be permitted to continue? Continued state regulation might prove costly and may lead to conflicting regulations; if so, the benefits to investors will be problematic. Hopefully, the SEC, the SROs, and the state regulators will cooperate to produce a uniform national standard for dealing with analysts' conflicts.

VI. CONCLUSION

The allocation of regulatory responsibilities between federal and state securities regulators has not always been logical or even coherent, because it is affected by politics and economic history. Even as this Article was being written, the traditional lines between federal and state responsibility for overseeing the conduct of public corporations was being changed in the U.S. by the passage of the Sarbanes-Oxley Act, which federalized the law governing corporate audit committees and yet left implementation of this legislation to SROs as well as to the SEC.[278] Similarly, implementation of the Financial Services Action Plan was limiting the ability of member state regulators to maintain national standards in the face of further harmonization of EU

276. *See* Sarbanes-Oxley Act of 2002, 107 Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.). *See also* Greg Hitt, *Bush Signs Sweeping Legislation Aimed at Curbing Corporate Fraud,* WALL ST. J., July 31, 2002, at A4.

277. *See supra* text accompanying notes 147–53.

278. Sarbanes-Oxley Act of 2002 § 301.

law.[279] Yet, in the wake of the financial fraud scandals roiling the stock markets in the U.S. and Europe, both federal and state securities regulators were endeavoring to assert their jurisdiction over wrongdoers. In short, the subject of this Article is current and fluid.

Although some long-term principles would appear to animate legislators in their reactions to financial crisis, fixing an immediate problem often compromises such principles. As a general matter, in the U.S. regulation of financial institutions and products has been given to federal regulators and the rules pertaining to corporate governance have been left to the states. Investor protection historically has been a matter of dual federal and state regulation. Yet, when Congress believed that duplicative regulation and strike suits were impairing capital formation, it enacted the NSMIA and then the SLUSA, impinging upon both state securities and common laws.[280] When Congress believed that corporate law was not adequately protecting investors from fraud, it impinged upon state corporate law through the Williams Act and then the Sarbanes-Oxley Act.[281]

In Europe, there has been an overriding concern with the need for economic integration and recognition that uniform financial regulation can be a barrier to competition. Yet, despite the importance of the single passport, host countries have thus far been able to impose customer protection principles upon financial institutions from other countries.[282] Further, the principle of subsidiarity has been utilized as a brake upon harmonization and integration. Impatience with the progress of financial market integration and a fear that the European capital markets were not sufficiently competitive with U.S. capital markets led to the Financial Services Action Plan and the Lamfalussy Report — initiatives that evidenced regulatory competition on an international level.[283]

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279. *See United Kingdom Moves to Protect EC-Threatened Stock Listing Regime*, 34 Sec. Reg. & L. Rep. (BNA) No. 31, at 1309-10 (Aug. 5, 2002).

280. *See supra* notes 64–65.

281. *See supra* note 167.

282. *See* Gerard Hertig, *Imperfect Mutual Recognition for EC Financial Services,* 14 INT'L REV. L. & ECON. 177, 181 (1994).

283. *See supra* text accompanying notes 188–199. *See also* Amir N. Licht, *Regulatory Arbitrage for Real,* 38 VA. J. INT'L L. 563 (1998).

As securities markets have become national and even international and significantly affect the national economic welfare in the U.S. and the EU-wide markets in Europe, there has been a trend toward federalizing securities regulation. This trend probably will continue. Yet, when local investors and constituents are implicated, state regulators become active.[284] Only when dual regulation becomes unnecessarily costly or at odds with federal regulation, is it likely to be supplanted by federal regulation.

The availability of the Supremacy Clause under the U.S. Constitution appears to provide a mechanism for dealing with policy conflicts between federal and state law that is not available in Europe. The European Court of Justice has nevertheless managed to invalidate national law that is contrary to the principles of the TEU.[285] In both the U.S. and Europe, the political process whereby securities regulation is allocated between federal (or EU) and state authorities is extremely complex and time consuming. This means that regulatory change generally is incremental. Further, interest group pressure is a factor not only with regard to the substance of regulation but also whether regulation is imposed by federal, state, or SRO administrators.

U.S. constitutional law and the TEU provide theoretical frameworks for reconciling federal and state interests in securities regulation. Developments in the securities markets, including corporate scandals, financial failures, and political compromises explain how such theory is applied, sometimes logically but often haphazardly. Although investor protection should be the guiding principle for allocating regulatory responsibility, so many complex factors go into promoting investor confidence that it is difficult to determine whether the SEC (or an organ of the EU) or state regulators should necessarily be the guardians of investors. Prevention of systemic risk, for example, gives federal securities regulators some responsibility for maintaining the long-term financial health of the securities industry. Further, promotion of capital formation is a federal goal that underlies investor protection. Concern about the viability of pension plans is another growing policy consideration in balanc-

284. *See supra* text accompanying notes 147–56.
285. *See supra* note 177.

ing the interests of investors against those of business. State regulators tend to view investors more as consumers than as capitalists, but on the other hand have an interest in encouraging businesses to incorporate and do business within their jurisdictions. These classic tensions between finance and industry frequently translate into constitutional law tensions.

Regulatory competition exists between federal and state agencies and courts, as well as between federal financial regulators, and between regulators in different countries. This competition frequently is fomented by affected business interests, but can be reconciled through coordination and cooperation. In order for competing regulatory interests to be reconciled, however, regulators must have the same vision of which investor interests require protection and how that protection should be achieved.

PANEL II: DISCUSSION TRANSCRIPT

PROFESSOR KELLY: Professor Strauss.

PROFESSOR STRAUSS: Thanks very much. And I'm sure with everyone else shares my appreciation for two such thoughtful and extraordinarily rich and well informed papers.

If you listened carefully to the gracious introduction that I got, you heard no particular evidence of acquaintance on my part with the world of corporate law or financial regulation as such. I'm an administrative lawyer. I've served in government for a while, but on the health and safety side. And sitting here in some way reminds me uncomfortably of the one time I taught a private law course at Columbia, which was contracts. On the first day of class I remarked that they had, my students had probably worked out that I was a public lawyer by experience, but that really the basic moves and skills that we would be practicing were common to all lawyering and maybe it would be helpful to them to think of me as a football coach who this year was also assigned to help the lacrosse team. This apparently produced panic among my students and so far as I could tell was the only thing I said during the semester that stuck in their memory. Nonetheless, public lawyer, administrative lawyer that I am, and this shapes the perspectives and reactions that I bring to these two fine papers.

And maybe the place to start is with Eliot Spitzer, who has recurred again and again during today's talks. And perhaps it's possible to see this in a slightly different way by looking at Merrill Lynch as an example of the supermarket, of the integrated financial creation. That suffered, at least so it appeared through the eyes of Eliot Spitzer, and I tend to see some merit in it, suffered from some internal conflicts of interest that had not been identified in the regulatory sphere. So maybe this is emblematic of the problems presented to us by supermarkets, but I wonder if it's emblematic of the appropriateness of response through a single super regulator, or whether in fact the availability of an Eliot Spitzer or an SRO or a Securities and Exchange Commission, a variety of possible avenues of response to which the at least potentially mischievous participant in the supermarket will need to be responsive, of which it will need to be aware isn't a significant safeguard on the part of us, the folks who are subject to their power and possible market manipulation.

Well, you'll recognize in the comments a common feature of American thinking about law and constitutional affairs which sharply distinguishes us from our European colleagues, who tend to look for single grand schemes that will bring all things together beautifully in a coherent way. And we like to muddle. And checks and balances, that's an American theme and I suppose it's in some respect my response to the papers is to say, well, these are on the whole a good thing.

I have four principal areas of response, interrelated. One of them I can deal with very briefly, because Roberta [Karmel] said it so well, is the adventitious nature of the American developments.

The second, the challenges and possibilities of what I'll call cooperative federalism, but it extends past federalism to private organizations like the SRO's.

A third, and particularly important, I think, what I'll call the limitations of expertise as a premise for regulation. That is, the need to be concerned with the nature of the regulator. My colleague Jack Coffee was not able to be with us today, but if you looked at the original program you saw that he was going to deliver a paper on the problem of agency capture. Well, the problem of agency capture is a real problem, and if there's only one agency to capture it's a much larger problem than it is if there are twenty or thirty of them. That's harder to do, albeit that introduces as well some inefficiencies of a nature that's important to be aware of.

And finally, and related to that, the centrality of private interests to effective regulation.

So the adventitious nature of American developments. American politics simply aren't organized to produce rational design, a precision mechanism of government reflecting exquisite and comprehensive rationality. And it starts with the fact that we don't have parliamentary democracy in this country. And so members of Congress are free to go off on their own and not subject to the discipline of an executive who thinks he or she knows what it is he wants.

It seems to me not to have been an accident that the creation of the unitary system of regulation in Great Britain was attended by a remarkable political change in that country, although, Claire [Kelly], you didn't address it in quite that way. Here legislative action is rarely the result of thoughtful and comprehensive drafting, like the civil codes of Europe, but it

tends to be a spontaneous response to the perceived urgencies of the moment, developments in the nature of the market to developments in its size and the number of its firms, to economic crises, to particular outbreaks of unscrupulous or at least unacceptably hazardous behavior. And the resulting crazy quilt of institutions that can't be given a rational or scientific explanation. Its parts grew out of the crises, needs and changes of previous times and they stay with us until new crises, needs and changes cause us to adjust them.

And I noticed in this respect, that in talking about the possibilities of a comprehensive regulator, there's been this strange possible participant that's appeared and disappeared at various times during the course of the day.

We've tended to talk about banking, insurance and securities. Every now and then the CFTC and what it regulates has reared its head and then it's disappeared again. Commodities aren't on the general map that we've been talking about today, but I thought we heard enough about commodities this morning, and particularly about those things that people could pretend were commodities, manipulate into regulation by commodities regulators instead of securities regulators, to think that that too is a necessary part of the theoretical structure.

Well, I have to say that, in a similar way, it seems to me that Europe's issues and institutions are and will be precisely the product of becoming Europe, of having to accommodate to new realities of markets and the information age. The old jealousies, languages, preferences, legal systems, governmental styles, and expectations and habits of Europe. And it's a lot tougher, with twenty languages and governments that have been in place for two or three centuries or longer, than it has proved to be — much bnger — than it has proved to be here, I would suppose.

We've been talking about Europe and the United States, but I suppose it's also hard to imagine in a globalizing economy that these developments are going to stop with Europe. As the nature of markets and market participation change, law and institutions are going to follow, because they have to. And so tomorrow this conference will be talking about some global regulator of the securities markets.

But the institutions and professional alignments and expectations will grow up around whatever arrangements we make, as they have around the arrangements we've already made, and

then became stuck. Not rational, necessarily, but not unworkable, either. And so we live with them until they're proved inadequate.

So the challenges and possibilities of cooperative federalism. Europe, as I now understand it, faces the imperatives that drove the expansion of our federal government's activity during the New Deal, when the Securities and Exchange Commission was born. There is now a European economy. It didn't used to exist in the way in which it does today. It has needs that can't be safely entrusted to individual states that might be too easily tempted into efforts to favor their own citizens, that could produce a race to the bottom or, worse, war, economic or real. It certainly has done that in the past, in the history of that continent.

So I think we have to expect European institutions to emerge. But what will be the character of their political control in a Europe that still lacks for itself genuine democracy? That's an issue that we haven't heard talked about really at all today, the nature of the political controls over these institutions, either within the nation or, perhaps more importantly, within Europe, itself. How can we expect these institutions to interact with the still empowered state institutions, each in this case acting under unique conditions of language, political history and governmental institution?

I think among the lessons of the American experience is that ideas like subsidiarity, however powerful they may be intellectually, will not inevitably constrain the growth of central institutions. Thomas Jefferson, in a corresponding situation long ago characterized the reasoning possible under the equivalent American principle as the house of cards, as house of cards reason. You can just build on it until you get to the point of intellectual collapse, I suppose.

As the economy of Europe becomes more and more interdependent, what individual states can effectively accomplish, each within the limits of its own jurisdiction, will become more and more subject to rational question. And the destruction of such arguments by experience was almost precisely the experience that we had during the Great Depression of the 1930's that brought central federal regulation of the financial markets.

So then the thing to see, it seems to me, is that the federalist argument doesn't just produce regulation here or there, but one has the SEC operating in cooperation with the SRO's, with pri-

vate regulators who must also in some respects cooperate with state authorities in many federal regulatory programs — if not the SEC, state regulators in turn operate under the supervision of federal as well as state authorities. And that's what we hear about as being in the future of Europe, subject to the loss of their powers, or some of them, if they don't satisfy their federal overseers that they are satisfactorily carrying out their responsibilities.

Politically, I suppose, having national authorities carry out European policies under supervision — one way to understand the elegant charts of Professor Di Giorgio's and Dr. Di Noia's paper is both politically and legally attractive. It appears to retain national power and it subdues possible questions of legality and authority for the imposition of legal sanctions. But when they're thought to be national departures from the European norm, when the question is sanctions against those national authorities or perhaps the suspension of their responsibilities in favor of direct European action, which are the things that can happen in this federal system, then the difficulties indeed may be substantial. No one looking at the contortions that our Supreme Court is now going through over the relations between the state and federal authority, even under a system as long established and as firmly grounded as our own, could possibly think otherwise.

So then the limitations of expertise as a premise for regulation. Both papers, again, and perhaps especially the Di Giorgio-Di Noia paper, are written from a perspective of confidence in what I might call virtuous objectified expert regulation. This is the unseen quality of Professor Schooner's superheroes this morning. It was not just that they were men of steel or superb detectives. It's also that they were rigorously honest, and they always acted on the public's behalf. Do we have that kind of confidence about all of our regulators all of the time? And what mechanisms do we have in place to secure their honesty, their responsibility, their political accountability?

It's striking, in a way, that the agencies we've been talking about at the federal level are all so-called independent regulatory commissions. That is to say, they're at some remove from the President, maybe a little vulnerable to the Congress. The chairman of one of the IRC's once remarked that being the chair of an independent regulatory commission meant that you had to

appear naked in front of the 535 members of the United States Congress.

Maybe they're a little bit vulnerable to the Congress, but we've set them up with the idea that they ought to be outside politics. No one has solved the constitutional question of how we can have the Federal Reserve in relationship to the Constitution that we have, given the extraordinary independence that it's had. We've been rather lucky. But what does the fact of these, I'll say for the moment, three independent regulators — the SEC, the CFTC and the Fed — suggest for the possibilities of a committee of coordination?

We have a committee of coordination. It's called the President, right? And what Congress has deliberately done for its own reasons, which one can find explained in political history — Alexander Hamilton argued rather strongly for this — we have to separate the money supply from politics — is to put these regulators at the farthest remove possible within the framework of our constitutional structure from the committee of coordination. And whatever that impulse is, shouldn't we expect it also to work and to trouble the possibilities of coordination in this context?

Capture is seen as corruption or failure — and it sometimes is — and not as the product of legislative choice — as it also sometimes is — or political change — as it equally may be. The general administrative law scholarship has at least moderated, if it hasn't entirely abandoned, its faith in expertise for visions that attempt more room for politics as a desirable, honest, inevitable element of government. And we need to think about how that can be achieved in these areas.

So a consequence, then, seems to me is to bring into prominence questions about the transparency of regulatory decision-making, about expansive participation in regulatory decision-making, about political controls over its outcome, that so far today I really haven't heard addressed. But it seems to me if we're engaging in discussions about institutional design, in matters as important to us as the monetary supply or the stability of our financial markets, we ought to be thinking about it. It's particularly important in respect of policy making, rule making, in the American jargon.

In the past, Europeans have been content to treat policy-making simply as an output of parliamentary government and not be very concerned about how it happened. It's changing a

little bit, and I should think gratifyingly. The American approach is very different. Particularly as policy-making moves out of the hands of ministries who can be controlled by a vote of no confidence in the parliament, it warrants a good deal of attention.

If independent regulatory commissions offer no assurance of pure expertise, one rule maker for all financial institutions would diminish further the claim to expertise and raise further the needs for mechanisms to assure consensus and transparency. So when we're thinking about how we want regulatory regimes constructed, I think it behooves us to think rather aggressively about the controls and politics that will operate on them and in them, not only in the first flush of enthusiasm for their mission, but also over the longer term.

I mean, you may know the story of the creation of the first American independent regulatory commission, the Interstate Commerce Commission. The railroads were at first alarmed because this had come about out of basically a populist upswell in response to the inability of the states to control the price gouging by the railroads. The Attorney General took the president of some railroad aside and said, don't worry about it. You'll live with this for five or ten years and then it will be yours. And he was, of course, right.

The failures of many agencies can, I think, be ascribed to the absence of such thinking. The great American scholar, Louis Jaffe, in a wonderfully titled piece he wrote near the end of his long career, *The Myth of the Ideal Administration*, remarked on his conviction that we get about as much regulation as our political leaders are convinced we're going to effectively demand. Keeping the conditions of public awareness necessary for effective political demand is a challenging task. And I expect it will be a particularly challenging task in Europe.

So, finally, the centrality of private interests, of the many voices to effective regulation. Both papers do express a concern with the problem of capture, which can be a problem. Yet, depending on how we look at it, it might also be a strength, or even a precondition.

One of the things about having any number of agencies is that different participants in the regulatory framework may tend to be served by different agencies among the groups that are there. Certainly Professor Di Giorgio and Dr. Di Noia might be right, that one risk of a single unitary regulator is that

it might more easily succumb to the subversion of collusive relationships with the intended object. And regulatory competition has the possible virtue of avoiding this problem at the cost of the inefficiencies that Professor Jackson suggested this morning. But I do think it's worth paying attention to all those groups that are interested in the nature and extent of regulation as well as the bureaucrats and politicians, themselves, and acknowledging that they have different ends and views, that they're competing.

So among those that come to mind in respect of the regulatory schemes we've been talking about today are individual investors, institutional investors like pension funds, investment professionals, like the folks at, I'll say Merrill Lynch, but they're more than a brokerage house these days, banks, insurance companies, entrenched corporate management — we haven't heard so much talk about them, but they're in many respects the real objects of regulation, whether they're interested in securing capital or maintaining power — politicians, that is to say, legislators and executive officials, members of the entrenched civil service, who have their own axes to grind and their own strong sense of how their activities serve the public interest.

And we might also think here about the implications of those private recoveries and the defense fee. The defendants in those cases have to pay their lawyers in order to keep the price as low as $4 million. So it must be higher than that. The implication of all of this for the regulated.

Real problems for rationalization. But it really is harder to capture the SEC and Eliot Spitzer than it would be to capture the SEC or Eliot Spitzer alone. So these are perhaps also elements of the complex systems by which we hope to keep scoundrels in their holes and public confidence in our financial markets high. Thanks a lot.

PROFESSOR KELLY: I'd like to give the presenters a chance to perhaps respond and then we have some time for questions from the floor.

PROFESSOR DI GIORGIO: Just a quick comment to the very interesting points that you raised. Of course, yes, what you said about the political control is what we call the accountability. You want to have independent but accountable agencies, and this is an important problem that probably deserves one or more papers.

It is already a big issue in the European Monetary Union, because . . . we have delegated monetary policy to the European Central Bank, which is a fantastic institution, technically well equipped, and has all the instruments to reach its targets. But the problem is that it also sets the targets. So usually you don't want to have a central bank which is politically completely independent, because inflation rate is a tax and in democracies taxes are usually selected by the parliament.

So this is already a problem in Europe and we have to deal with this problem also in the context of financial market regulation.

PROFESSOR STRAUSS: It's a tax only on creditors.

DR. Di NOIA: Another quick point. Also you raised the question if we can trust — I mean, the . . . honesty of these regulators. I hope — I'm coming from a regulator, so I think we can trust them. Probably we cannot trust their ability to regulate and to supervise. So the real problem is, at least for the Italian institutions in this period in the last years, is that they really are . . . lacking expertise. And in a sense they are — many people like me go away, go in the market. But there is not a tradition of the other way back.

So in a sense they're not specializing enough. This morning it was pointed out in order to supervise derivatives you need really in financial innovation, you need people that really know the market and specialized people. And probably this is what the institution, even the European institutions, still lack. And this is, I think one of the biggest problems.

PROFESSOR STRAUSS: Who will watch the watchers is in some respect the defining question of American constitutional law.

DR. Di NOIA: This is off the topic.

PROFESSOR DE GIORGIO: For this you should provide a good mechanism to have incentives for good regulation. But you cannot just trust the regulator. That I agree.

PROFESSOR KARMEL: I would say only that I think the issue of accountability is indeed a very important issue. And it's probably because Americans don't trust power, whether it's in the private sector or in government, that we have such a tremendously chaotic system of regulation. Because I think there is a fear that if a single regulator gets too much power, that power will be abused and that there will be insufficient accountability.

And at the federal level, our system of accountability primarily is Congressional oversight committees. And watching that process over the course of much of my career, I would say it's not very inspiring. And it doesn't give one a sense that it would be a good idea to have too much power in a single agency that has accountability only to some Congressional oversight committee.

PROFESSOR KELLY: I know it's late in the day. We have time, though, for a couple of questions from the floor.

QUESTION FROM AUDIENCE: I just want to make it clear that Batman is a vigilante [laughter]. I actually had a question for Professor Di Giorgio about your comments on the Bundes Bank. I wonder if in Europe, in the Euro area countries — those few countries where the bank supervisor is at the central bank which is no longer central — whether that fact might be an impediment to a working proposal. Are those banks going to be reluctant to give up what little task — the one thing that they still have is really a formal role in supervisory, since they no longer make monetary policy. I'm just curious what you think about that.

PROFESSOR Di GIORGIO: Of course they are reluctant. And they also have another powerful instrument, which is the European Central Bank General Council. The governing body, is made up of twelve national governors and six central ones. And so the weight of the decision is in the periphery and not in the center of the body.

Actually, there is a paper that before Carmine mentioned of the European Central Bank, in which there is big support for the important role of central banks in banking supervision, although the trend in Europe is totally the opposite.

PROFESSOR STRAUSS: Is it possible to remark that that scheme, like our Fed, I think, is institutionalized capture? That is to say, it is the banking business that is essentially in control of the banking regulator.

QUESTION FROM AUDIENCE: This is for Professor Karmel. Would you comment in terms of the federal/state dynamic in the securities area that perhaps the state role is really one maybe of accountability to the SEC. When you look through the history, that the states brought the issue of the penny stocks and the blank check line pools, and you had the 1990 Act, they brought to the attention — and there were federal rules then with respect to those, Rule 419.

Then you had the states bring the issue of the microcap fraud and federal rules on that. Online trading, day trading, and even as late as Sarbanes-Oxley, we now have in federal law that state enforcement actions, certain state enforcement actions now become the statutory disqualification under the '34 [Securities Exchange] Act for certain brokers and associated persons.

So I'm thinking in terms of not so much state and federal in regulatory competition, in the sense of competing against each other, but more or less an accountability, and when something is brought to the federal government's attention through state actions, whether they be studies done by the states or whether they be actions by attorneys general such as Eliot Spitzer, that the federal government then, for national problems, should address it and then the states kind of recede. And that's really kind of our accountability.

PROFESSOR KARMEL: You could look at it that way.

I think another way to look at it is that it has something to do with this problem of capture.

The SEC is focused on the markets and on the securities industry, on capital formation, and to some extent institutional investors. Whereas the states think of securities regulation more as consumer protection, that they're more focused on protecting individual investors who believe they've been ripped off by some fraud in the market.

So I think it's in part this difference in focus that gets the states very excited about some kinds of frauds that you wonder, well, why didn't the SEC ever focus on this. Because that's not what they're looking at most of the time.

And, yes, you can look at it as an accountability, but I don't think the purpose of the states acting is really to make the SEC more accountable. It's to protect the residents within their state that they feel need some protection.

QUESTION FROM AUDIENCE: In terms of this accountability concept, I know the French have a delict that sounds in the Americanese as the failure of a supervisor, a public supervisor to do its job.

I think the House of Lords has twice in recent years been seized of the question of whether community law sets up such a tort against the Bank of England. They said no, but it has refused in a separate decision, summary judgment, what we call summary judgment, when one makes out that the common law should evolve to consider a tort of administrative neglect.

Now, this, of course, would be startling news over here. But does that have a controlling element in Europe? Is there such a delict, tort, I have no idea of the Italian usage.

PROFESSOR FERRAN: In the U.K., at least, the FSA enjoys immunity from claims for negligence, which I believe is sort of common practice for banking regulators to have, and that's been extended to the FSA generally. But it doesn't have immunity from deliberate misfeasance. And that's what the issue has been in the cases you mentioned. It also doesn't have immunity for human rights violations, which is the European Convention dimension. And it's as yet unclear what exactly that will allow in sort of challenges.

QUESTION FROM AUDIENCE: [Unintelligible]

PROFESSOR FERRAN: Exactly.

DR. Di NOIA: Formally, Italy, at least, for example, CONSOB [Commissione Nazionale per le Società e la Borsa], but there is not a formal immunity. Some judges actually — I mean, there are some cases not yet solved, and some people tried to take CONSOB to court in cases of not having controlled or supervised that well. But it's not clear, and we are actually curious, because there is no final decision in many of the cases, because according to some people, when they sued CONSOB of the administrative authority, and they want to pay a lot of money.

On the other side, there's an administrative authority, of course, all the decisions of CONSOB go to the administrative court there to separate decision. But of course they have no direct input on, let's say, private investors for the central bank.

And then also for the sanctions that are issued by CONSOB or by the Bank of Italy against the, let's say, banks or securities firms, there is a sort of appeal. Formerly, the sanctions are proposed by the bank or by CONSOB to the treasury. Then the treasury issues a decree with a fine, let's say. And you can also go to appeal to court for that.

PROFESSOR KELLY: Any other questions?

Well, I think I'd like to take this opportunity to thank all of our presenters today and our commentators. Also to thank our hosts, the *Center for the Study of International Business Law* and the *Brooklyn Journal of International Law*. In particular, Professor Karmel and Professor Fanto for organizing this event. Also Michelle Scotto and our symposium editor, Jessica Lubarsky, as well as the students of the *Journal* and the student fel-

lows of the *Center* who worked here today. And we look forward to seeing the papers and commentaries published in the *Brooklyn Journal of International Law*. Thank you.

NOTES

ASSET SECURITIZATION: IS IT A RESOLUTION OPTION FOR CHINA'S NON-PERFORMING LOANS?

I. INTRODUCTION

China's banking industry has been straddled with a staggering number of non-performing loans ("NPLs").[1] These bad loans were extended by China's state banks to inefficient state-owned enterprises ("SOEs"), as well as failed real estate projects during the time of economic overheating in the mid 1990s.[2] In order to overhaul its fragile banking system, the Chinese government has taken a series of measures over the past decade to clean up the balance sheets of four major state banks.[3] One significant step was the creation of four Asset Management Companies ("AMCs") in 1999, which purchased at face value about USD170 billion of NPLs from four major state banks with the ultimate task of disposing of these assets.[4] To date, the AMCs have recovered about a quarter of the transferred portfolio through various techniques including loan resale, public auction, debt restructuring, and debt to equity swaps.[5] Recently, with governmental support, the Chinese AMCs have also begun

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1. The official NPL ratio at four major Chinese state banks was given in 1999 as 25% of the total loans outstanding. For several years, the government denied the scale of the problem and dismissed unofficial estimates that put the ratio at 40% or more of the total loans outstanding. *See infra* notes 35–39 and accompanying text. Nicholas Lardy, a China expert at the Brookings Institution, however, recently estimated China's NPLs to be USD500 billion, or about 50% of the total. *Casino Capital: China's Financial Markets Are Wild and Often Less Than Wonderful*, *in* THE WEAKEST LINK: A SURVEY OF ASIAN FINANCE 10, 12 (supplement to ECONOMIST, Feb. 8, 2003) [hereinafter *Casino Capital*].
2. *See infra* notes 40–47 and accompanying text.
3. *See infra* notes 60–63 and accompanying text.
4. *See infra* notes 65–71 and accompanying text.
5. *See Casino Capital*, *supra* note 1, at 12.

to explore asset securitization as an alternative for the expeditious and efficient resolution of NPLs under their charge.[6]

Asset securitization[7] refers to a specific form of financial transaction in which an originator pools certain types of illiquid assets (typically loans or receivables) and transfers them to a special purpose vehicle ("SPV").[8] The SPV, in turn, issues securities (usually bonds, but can also be equities) collateralized or backed by the transferred assets.[9] The SPV pays investors of these asset backed securities ("ABSs") interest and principal out of the cash flow arising from the underlying assets.[10] Investors then purchase the securities based on their evaluation of the transferred assets' risk, without concern with the originator's financial condition.[11]

Securitization is beneficial to originators through risk transferring. For corporations, securitization offers a new and potentially cheaper form of financing.[12] For financial institutions, such as banks that hold large loan portfolio, securitization not only provides alternative financing, but also allows them to address regulatory requirements, such as capital adequacy and lending limits.[13] Therefore, a financial institution originator may achieve a good match between assets and liabilities.[14]

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6. Interview with Kaisheng Yang, Chairman, China Huarong Asset Management Corporation, in Beijing, China (Jan. 9, 2003) [hereinafter Interview with Yang].

7. In this Note, asset securitization and securitization are used interchangeably. For a general discussion on securitization, see TAMAR FRANKEL, SECURITIZATIONS: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991 & Supp. 1999); STEVEN L. SCHWARCZ, STRUCTURED FINANCE: A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION (3d ed. 2002) [hereinafter SCHWARCZ, STRUCTURED FINANCE]; THE SECURITIZATION OF FINANCIAL ASSETS (Jason H.P. Kravitt ed., 2d ed. 1996 & Supp. 1999); Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TULANE L. REV. 101 (1997); Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061 (1996); and Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133 (1994) [hereinafter Schwarcz, *Alchemy*].

8. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1–3.

9. Schwarcz, *Alchemy, supra* note 7, at 135.

10. *Id.*

11. *Id.*

12. IAN H. GIDDY, ASSET SECURITIZATION IN ASIA 2 (2000), *available at* http://pages.stern.nyu.edu/~igiddy/ABS/absasia.pdf.

13. According to the Basel Committee on Banking Supervision, banks that securitize assets are able to accomplish several objectives: (1) reduce regula-

For investors, ABSs provide better yields than those on comparable corporate bonds and enable them to diversify their investment portfolios.[15] In addition, the investors' risk preferences may be accommodated through special deal structures.[16] Finally, since the ABS issues usually are large and have high credit ratings as a result of credit enhancements, these securities tend to be liquid and may be actively traded in secondary markets.[17]

In a typical asset securitization transaction, the SPV issues securities backed by "good" assets with a proven track record of repayment streams.[18] During the period of 1989 to 1995, however, the Resolution Trust Corporation ("RTC"), a special agency sponsored by the United States ("U.S.") government, successfully utilized the asset securitization to dispose of under- and non-performing loans taken over from failed savings and loan associations.[19] The U.S. experience has since inspired some Asian economies, such as Japan, Korea, and Taiwan, to employ securitization as a method to dispose of their bad bank loans.[20]

This Note argues that given the magnitude and urgency of China's NPL problem, the AMCs should explore all possible resolution methods, including securitization, to prevent their portfolios from rapidly decreasing in value like a melting ice cream.[21] The Chinese AMCs, however, may only be able to utilize asset securitization to recover certain suitable NPLs, because there exist substantial obstacles to a large scale NPL se-

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tory capital requirements; (2) obtain an additional source of funding, generally at lower cost; (3) enhance financial ratios; (4) manage portfolio risk; (5) diversify their portfolios. *See* BASEL COMM. ON BANKING SUPERVISION, CONSULTATIVE DOCUMENT: ASSET SECURITIZATION 1 (2001), *available at* http://www.bis.org/publ/bcbsca06.pdf.

14. GIDDY, *supra* note 12, at 2.

15. *Id.*

16. *Id.* at 3–4.

17. *Id.* at 3.

18. *See* SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1–2; *see also* GIDDY, *supra* note 12, at 3.

19. *See infra* notes 156–58 and accompanying text.

20. *See* discussion *infra* Part V.

21. Kaisheng Yang called the value decrease of NPL portfolio as "ice cream effect:" the bad loans are like "an ice cream you are holding in your hand, which, if you hold it too long, will melt away." Interview with Yang, *supra* note 6.

curitization program in China. The most prominent hindrances include the peculiar nature of Chinese NPLs, the immaturity of the capital markets, and the inadequacy of China's existing legal infrastructure.

Part II of this Note provides an overview of China's banking system and NPL problem. Part III then introduces the general features of asset securitization along with a cost-benefit analysis. Part IV examines the desirability and feasibility of distressed loan securitization, followed by a case study of the RTC securitization program. Part V discusses the securitization development in East Asia with some details on the Japanese and Korean cases. Part VI considers the market conditions for NPL securitization in China, identifying as securitizable certain types of NPLs held by the Chinese AMCs. Part VII examines China's current legal and regulatory framework relevant to securitization, and proposes for special legislation to facilitate securitization development. Part VIII concludes by stressing that China must further liberalize its capital markets and establish a transparent legal system in order to pave the way for launching NPL securitization market.

II. CHINA'S NON-PERFORMING BANKING LOANS

This Part first provides an overview of China's banking system. It then discusses the seriousness of the NPL problem, as well as its negative impact on the country's financial stability and economic growth. This Part ends with a review of the Chinese government's step to attack the NPL problem.

A. Evolution of China's Banking Industry

China's banking sector saw considerable institutional transformation in the last two decades of the twentieth century.[22] For a long time, China lacked a sophisticated banking system. Until the early 1980s, the People's Bank of China ("PBoC") performed the mixed functions of both a central and an operational bank. In 1984, the PBoC's operational business, consisting mainly of short-term industrial and commercial credit as well as related payments (i.e., granting loans for working capital),

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22. For a comprehensive discussion on the evolution of China's banking system, see NICHOLAS LARDY, CHINA'S UNFINISHED ECONOMIC REVOLUTION ch. 3 (1998).

were assigned to a newly established state bank, the Industrial and Commercial Bank of China ("ICBC"). Accordingly, PBoC started to perform solely the functions of the nation's central bank.[23] ICBC, along with the Agricultural Bank of China ("ABC"), China Construction Bank ("CCB"), and the Bank of China ("BOC"), operated through the late 1980s and 1990s as the four major so called "specialized" state banks (hereinafter "the big four"), dominating the country's financial landscape.[24]

During the 1990s, the Chinese government accelerated the process of the banking system reform. The Central Banking Law enacted in 1995 formally granted the PBoC the legal authority to function as a central bank. Today, the PBoC holds the role as the lead supervisor of China's financial institutions.[25] In addition, since 1994, the government began to transform the big four into commercial entities. At the same time, the prior division of their business scope along the client sector line gradually diminished, allowing more competition among the big four. Beginning in the mid 1980s, the government relaxed restrictions on the banking market entry, granting licenses to a number of new commercial banks and nonbank financial institutions. Foreign banks were also permitted to establish their operations in China, but were subject to severe restriction on both geographic and sectoral scope of domestic currency business.[26] Up to the year 2000, only 32 licenses were granted to foreign banks to handle such business, all of which are in Shanghai and Shenzhen.[27] An even smaller group of them is allowed to borrow from and lend to local banks. When

23. *Id.* at 63–62.

24. *Id.* at 80.

25. A complex web of government authorities oversees the country's banking activities. The regulatory framework can be generally broken down among the PBoC, the Ministry of Finance ("MOF"), the China Securities Regulatory Commission ("CSRC"), the State Administration of Foreign Exchange ("SAFE"), the Ministry of Foreign Trade and Economic Cooperation ("MOFTEC") and the State Economic and Trade Commission ("SETC"). Each regulator, however, has individual preferences and objectives in its regulatory duties. ERNST & YOUNG, AN OVERVIEW OF THE NON-PERFORMING ASSET MARKET IN THE PEOPLE'S REPUBLIC OF CHINA 10 (2001) (on file with the author) [hereinafter ERNST & YOUNG REPORT].

26. Karen Chan, *Development in Banking Law 2000: Global Banking — Asia/Pacific*, 20 ANN. REV. BANKING L. 32, 42–43 [hereinafter *Asian Banking 2000 Review*].

27. *Id.* at 43.

China acceded to the World Trade Organization ("WTO") in the end of 2001, it committed itself to opening up its financial sector to the outside world. Accordingly, after a five-year transitional period, the Chinese government will eliminate both geographic and customer limitations on foreign banks in conducting the local currency business, and foreign banks will eventually enjoy national treatment.[28]

Although the institutional landscape has become more complex,[29] the Chinese banking sector remains underdeveloped, even when compared to other Asian markets. The banking sector's main clientele is the state sector. For example, state banks extend most loans (about 80%) to state-owned enterprises, while the private sector receives less than 5% of total lending.[30] The services to their customers are limited to basic deposit, lending, and transaction banking.[31] Household depositors receive few financial services beyond maintaining their savings accounts. In fact, basic retail banking services, such as checking accounts for households, are rare, even in the largest cities. Credit cards, home mortgages, and car loans are still in their infancy stage. Meanwhile, other types of consumer credit still do not exist.[32]

B. The NPL Problem

China's effort to modernize its banking system has been burdened by mountains of bad loans sitting on the books of major state banks.[33] Chinese scholars estimate that the proportion of

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28. *Id.*

29. Currently, the structure of China's banking system consists of 4 state commercial banks, 3 policy banks, 10 national joint-stock commercial banks, 4 asset management corporations, about 88 city-based commercial banks, 3,240 urban credit cooperatives, more than 41,500 rural credit cooperatives, and approximately 162 foreign banks that maintained branches or representative offices. ERNST & YOUNG REPORT, *supra* note 25, at 8.

30. *The Long March to Reform China's State Firms*, ECONOMIST, Sept. 30, 2000, *available at* 2000 WL 8143861.

31. Stephen M. Harner, *China Watch: Beijing Blocks the Banks,* ASIAN WALL ST. J., July 20, 2000, at J10, *available at* 2000 WL 23745833.

32. LARDY, *supra* note 22, at 82–83.

33. For a thorough discussion of China's NPL problem, see Jianbo Lou, *China's Bank Non-Performing Loan Problem: Seriousness and Causes*, 34 INT'L LAW. 1147 (2000).

NPLs[34] to overall bank assets has ranged from 10–40%.[35] In 1999, the governor of PBoC, Dai Xianglong, officially recognized that the ratio of NPLs to total outstanding loans at the big four was 25%.[36] The Bank for International Settlements, in a 2002 report, estimated the NPLs accumulated by China's big four to be 42% of the total.[37] This figure is comparable to the highest levels of 40% to 60% for South Korea and Indonesia during the height of the 1997-98 financial crisis.[38] In 2001, Standard & Poor's ("S&P"), a credit rating agency, estimated that it would take about USD540 billion, half of China's annual GDP, to properly recapitalize the big four.[39]

Although an in-depth discussion of the causes of China's NPL problem is beyond the scope of this Note, a brief summary is helpful. Historically, the NPL problem roots from the prior regime of command economy. For decades during the pre-reform era, state banks served as mere conduits for the quasi-fiscal operations of government institutions, extending easy credit to loss-making SOEs, providing subsidy loans for agricultural procurement programs, and financing a variety of public investment projects according to the needs of state planning.[40]

Banking reform did not prevent NPLs from snowballing. While struggling to establish themselves as truly autonomous entities, the state banks were only to find the impossibility of

34. The identification of NPLs referred to here is made under China's old three tier loan classification system. The total figure of NPLs includes loans that were overdue for less than one year and might be recovered. The main body of the portfolio, however, consists of doubtful and bad loans that would have to be written off. Since 1998, a new five level system, more in line with the international standard, has started to be implemented in the industry. *See id.* at 1192 n.4.

35. *Id.* at 1147.

36. *See id. See also* Peter Montagnon and James Harding, *Chinese Central-Bank Governor To Reduce Bad Debt,* FIN. TIMES, Sept. 13, 1999, *available at* 1999 WL 21147750.

37. GUONAN MA & BEN S.C. FUNG, CHINA'S ASSET MANAGEMENT CORPORATIONS 2 (Bank for International Settlements, Working Paper No. 115, Aug. 2002), *available at* http://www.bis.org/publ/work115.pdf [hereinafter BIS WORKING PAPER].

38. *Id. See also, Review and Outlook: the Care and Feeding of China's Banks*, ASIAN WALL ST. J., Oct. 7, 2002, at A11, *available at* 2002 WL 23018599 [hereinafter *Review and Outlook*].

39. *Id.*

40. Fred Hu, *Sense of Urgency, A Race Against Time*, ASIAN WALL ST., Feb. 11, 2002, at J8, *available at* 2002 WL 3344150 [hereinafter *Sense of Urgency*].

allocating credit purely based on commercial considerations.[41] They continue to face strong, although perhaps less outright,[42] political pressure to rescue the financially deteriorating SOEs.[43] Furthermore, the banks' problem of lax internal credit risk control persists,[44] even though most banks have begun to pay more attention to the borrowers' repayment capability and loan collateral's quality. The lack of effective internal control and external oversight, coupled with the difficulty of obtaining reliable financial information on the SOE borrowers, seriously constrained the ability of state banks to prudently assess credit risk, resulting in the declining of their loan quality.[45]

In addition to the soft loans made to the loss producing state owned factories, NPLs also include failed commercial real estate loans. In the mid 1990s, a time of economic overheating, many Chinese banks lent excessively to commercial real estate development projects, mainly in Shanghai, Beijing and some other coastal cities.[46] A considerable portion of such loans became nonperforming when the overbuilding resulted in a market collapse.[47]

The NPL problem has a serious negative impact upon both China's banking reform and its overall economic growth. First, the mounting NPL portfolios on the big four's balance sheets stand as a formidable obstacle to their true commercialization. The huge amount of bad loans in fact contributed to the big four's profitability decline, undermining their competitiveness.[48] Significantly, the staggering figure of NPLs has already

41. *Id.*

42. In 1998, the PBoC terminated the long-standing credit ceiling system. *See* Dai Xianglong, *Wei Jianli Xiandai Jinrong Tixi, Jinrong Zhidu he Lianghao de Jinrong Chixu er Nuli* [The Objectives of a New Round of Financial Reform and Development], 2 ZHONGGUO JINRONG [CHINA FIN.] 6 (1998).

43. *See Sense of Urgency*, *supra* note 40 (pointing out that the fundamental cause of the NPL problem lies in the deteriorating performance and loss making of many SOEs, the state banks' main clientele). *See generally* LARDY, *supra* note 22, Ch. 2.

44. *Sense of Urgency, supra* note 40.

45. *Id.*

46. *See* LARDY, *supra* note 22, at 195–97.

47. *See id.*

48. The average profit margin of the big four during the period from 1995 to 1997 was only 0.26% and showed a decreasing tendency. In contrast, the profitability of the ten new commercial banks during the same period was 1.70% and showed an increasing tendency. One of the reasons that these

made the big four technically insolvent.[49] Liquidity, however, is currently not a problem facing China's state banks. Two reasons explain this coexistence of technical insolvency and high liquidity in the banking sector: (1) high domestic household savings,[50] and (2) limited investment outlets in the underdeveloped domestic capital markets.[51] The big four are kept afloat mainly on governmental support and the public's confidence in state banks.[52] Given the weight the big four carry in the entire banking system,[53] any wavering of public depositors' faith could cause a major bank failure, and the resultant systemic financial debacle would lead China into turmoil.[54]

The NPL problem also stymies China's real economy. On the microeconomic level, the accumulation of NPLs on banks' balance sheet distorts the incentives for both banks and SOEs. The so-called "adverse selection" influencing banking lending decisions[55] fostered the SOEs' excessive reliance on state banks, diminishing their willingness and capability to adjust production in response to market signals.[56] From a macroeconomics

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newcomers outperformed the big four is that they had a very low NPL level. It is estimated that the emerging commercial banks have NPLs accounting for only 2.3% of their outstanding loans. *See* Lou, *supra* note 33, at 1148, nn.14–15.

49. *See* LARDY, *supra* note 22, at 119.

50. *See* Lou, *supra* note 33, at 1159–62. In 1997, bank deposits and savings accounted for more than 80% of all household financial assets, securities only accounted for approximately 10%, and cash and other assets less than 10%. *See* Statistics Department of the PBoC, *An Analysis of the Direct Finance of Chinese Enterprises*, 9 CHINA FIN. (Beijing) 24 (1998).

51. *See* Lou, *supra* note 33, at 1159–62.

52. Commentators have observed that China's low national debt, high savings rate, and reform momentum have so far forestalled a disastrous crisis of confidence in the banking system. *See, e.g.*, Hugo Restall, *Examining Asia: Selling Debt, Restarting Reform*, ASIAN WALL ST. J., Dec. 19, 2001, at J11, *available at* 2001 WL 29659268.

53. As of 1998, the big four held 68% of the nation's deposits, 77% of all loans, and 75% of total banking assets, and employed 66% of those working in the banking sector. *See* Lou, *supra* note 33, at n.23.

54. *See* LARDY, *supra* note 22, at 201–02.

55. *See* Lou, *supra* note 33 at 1151–52

56. The "adverse selection" refers to the distortion in the process of loan decision making. Because of the heavy exposure of state banks to SOE borrowers and the large amount of NPLs in proportion to the bank capital, the bank managers, in fear of the banks' own failure, were forced to extend new workout loans to the ailing SOEs enabling them to service the existing outstanding debts. The managers of highly leveraged SOEs, on the other hand,

perspective, the soundness of China's financial sector has a major influence on the health of the overall economy. [57] China has a bank-centric financial system, where banks play a key role of channeling funds from households to industry and commerce. The banks' share of financial intermediation is almost nine-tenths, a ratio exceeding that of almost all other Asian economies.[58] Any contraction of bank credit therefore could significantly affect China's real economic growth. Some economists, for example, believe that the 1998 economic slowdown in China was partially due to the banking sector stress caused by the cautiousness of banks in their lending in response to the alarm of the Asian financial crisis.[59]

C. Steps to Resolve the NPL Problem

In the mid-1990s, the Chinese government began taking steps aimed at reversing the deterioration of state banks loan assets. It recognized that one reason for the existence of nonrecoverable loans was government pressure on state banks to make loans to politically important SOEs without giving regard to their repayment capability. As a result, the government set up three policy banks in 1994 to take over the pure policy lending function from the big four.[60] The government hoped that after creating these new policy banks, the big four would be run along more commercial lines. Subsequently, the 1997–1998 financial crisis that afflicted many of China's East Asian neighbors awakened the Chinese leaders to the dangers that a fragile banking sector could pose to the country's financial security and economic development.[61] Although China averted a crisis largely due to its financial insulation,[62] the government realized the urgent need to take sweeping measures in order to avert a systemic financial debacle. A significant step was taken

had no incentive to scrutinize their projects or to promote the firms' profitability, because they knew that banks have no choice but to keep lending. *Id.*

57. *Id. at* n.33 (citing literature discussing a significant correlation between financial development and growth in China and other countries).

58. *See* LARDY, *supra* note 22, at 16.

59. *See* Lou, *supra* note 33, at 1153.

60. *See Review and Outlook*, *supra* note 38.

61. In late 1997, a top-level national financial conference was held in Beijing in response to the rapidly unfolding Asian financial crisis. *See Sense of Urgency, supra* note 40.

62. *See* LARDY, *supra* note 22, at 197–98.

in 1998, when the Ministry of Finance ("MOF") issued RMB270 billion (USD33 billion) of bank restructuring bonds to recapitalize the big four, boosting their capital adequacy ratios to the internationally accepted level of 8%.[63]

However, with little change in the incentive structure at both the state banks and the SOEs, bank loan quality continued to decline and the big four's capital once again evaporated.[64] Consequently, the top priority of China's financial reform agenda was to promptly resolve the NPL problem. In 1999, the Chinese government created four asset management corporations (one for each of the big four),[65] taking a page from the U.S. experience a decade earlier after the savings and loans crisis.[66] The AMCs purchased at book value from the big four at total of RMB1.3 trillion (USD169 billion) NPLs extended before the end of 1995.[67] To finance this purchase, MOF issued RMB10 billion (USD1.2 billion) of 10-year bonds for each of the four AMCs, and PBoC also provided cash credit.[68] This massive transfer of NPLs from the big four's balance sheets to that of the AMCs effectively provided a second round of recapitalization for the big four.[69]

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63. *See Review and Outlook, supra* note 38. *See also*, Jun Ma, *Financial Liberalization: Slow and Steady*, 28 CHINA BUS. REV. 1216 (May 1, 2001), *available at* 2001 WL 13260974.

64. *See Review and Outlook, supra* note 38.

65. These AMCs are Huarong Asset Management Company for ICBC, China Xinda Asset Management Company for CCB, China Great Wall Asset Management Company for ABC, and China Orient Asset Management Company for BOC. *See* BIS WORKING PAPER, *supra* note 37, at 1.

66. China modeled its AMCs along the lines of the Resolution Trust Corporation (RTC) created in 1989 by the United States government. *See supra* note 157 and accompanying text.

67. *Id.*

68. *Id.* at 4.

69. The final cost to the Chinese government of the eventual write-offs plus the interest payments on the bonds could easily reach RMB 1 trillion (USD121 billion). Fitch IBCA, in their 2000 Sovereign Debt Rating Report, estimated that the worst-case scenario based on systemic NPLs of 40% and a 30% recovery rate would suggest a one-off charge equal to 20–25% of 1999 GDP. This scenario would raise the public debt-to-GDP ratio to 40–50%, roughly on par with Thailand, while higher interest payments could widen the budget deficient by an estimated 1–2% of GDP. Such a huge burden, which may still be substantially understated, would without doubt considerably strain the government's fiscal resources, even though the majority of the costs will not need to be realized until the AMC bonds are redeemed at maturity in 10 years. ERNST & YOUNG REPORT, *supra* note 25, at 18.

The Financial Asset Management Company Regulation ("AMC Regulation") promulgated in November 2000 by the State Council, the executive branch of the central government, subjects the AMCs to the concurrent supervision of the PBoC, MOF, and the China Securities Regulatory Commission ("CSRC").[70] The AMC Regulation delegates the AMCs with an ultimate task of recovering the transferred bad loans to the fullest extent.[71]

Major disposition options granted by the government to the AMCs include debt-to-equity swaps ("DESs"), loan resale, and debt restructuring.[72] Besides domestic sales, DESs have been one of the most significant actions taken by the AMCs to resolve bad loans. By the end of 2000, the four AMCs purchased RMB1, 488 billion (USD483.8 billion) of NPLs and completed 587 swaps.[73] DES deals completed by the AMCs, however, have received much criticism.[74] The DESs were conducted based on the assumption that relieving the SOEs from the burden of debt servicing would improve their financial positions because many of them were highly overleveraged.[75] It was hoped that through swaps the SOEs could eventually make public equity offerings to pay back the creditors turned shareholders, the AMCs, with their newly raised capitals. While this strategy may be effective in cases where the companies were financially distressed but potentially viable, there is a real danger that in many other cases the debt embedded SOEs may turn the DESs into a shell game of debt forgiveness.[76] Experts have pointed out that a change in SOE capital structure would not by itself improve the

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70. Financial Asset Management Company Regulation, art. 4 (Nov. 20, 2000), *available at* http://www.chamc.com.cn/English/index.asp.

71. *Id.* art. 3.

72. *Id.* art. 10.

73. Huarong has bought RMB505.6 billions (USD61.1 billion) NPLs, and completed 333 debt-for-equity swaps, Xinda RMB370 billion (USD44.7 billion), 168 swaps, Orient RMB266.5 billion (USD32.2 billion), 65 swaps, and Great Wall RMB345.8 billion (USD41.8 billion), 21 swaps. Nicholas Howson, *The AMCs' Debt-for-equity Swaps: Opportunity for Foreign Capital?*, 28 CHINA BUS. REV. 56 (2001).

74. *See, e.g., id*; *Review and Outlook*, *supra* note 38; Fred Hu, *China's Banking Reform: Pitfalls Ahead,* ASIAN WALL ST. J., Nov. 24, 1999, at J8, *available at* 1999WL-WSJA 30190857 [hereinafter *Pitfalls Ahead*].

75. The SOE average debt-to equity ratio is estimated to be in excess of 400% by some measures. *See id*.

76. *Id.*

managers' behavior or put the ailing companies on sound footing. Given the lack of meaningful means for the AMCs to enforce their shareholder rights, delinquent SOE borrowers have a strong incentive to abuse DESs to evade debts, further contaminating the already weak credit culture in China's state sector economy.[77]

The AMCs have also used portfolio sale to recover NPLs. Until recently, the AMCs made only a few sale transactions to domestic buyers.[78] Late in 2001, Huarong Asset Management Corporation ("Huarong"), the largest of the four AMCs in China, nailed down a landmark auction sale with two groups of major international investment banks.[79] This first international NPL sale in the country[80] was hailed by financial analysts as "a breakthrough for the management of distressed assets in China."[81] A year later, near the end of 2002, Huarong finally won approval of the deal by China's relevant financial authorities, including the PBoC, MOF and MOFTEC.[82] The foreign

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77. *Id.*

78. ERNST AND YOUNG REPORT, *supra* note 25, at 18.

79. The AMCs purchased NPLs from the big four at the loans' face value, perhaps reflecting the Chinese government's hesitation to recognize the low recoverability of the NPLs. Outside observers pointed out that this no discount transfer cast a serious cloud over the valuation of any further asset transfer by the AMCs to investors, because few buyers would purchase the NPLs at anything close to the face value, with no discount given the assets' real value. Edward S. Steinfeld, *Free Lunch or Last Supper? China's Debt-Equity Swaps In Context,* 27 CHINA BUS. REV. 2227 (2000).

80. *China Completes Initial NPL Sale*, BUS. WORLD, Dec. 13, 2001, *available at* LEXIS News.

81. James Kynge, *Consortium Agrees Deal Over Chinese NPLs*, FIN. TIMES, Nov. 30, 2001, at 31, *available at* LEXIS News.

82. *Foreign Capital Allowed To Handle Non-Performing Assets in China*, ASIA PULSE, Dec. 3, 2003, *available at* LEXIS News [hereinafter *Foreign Capital Allowed*].

With the green light from regulators, two joint ventures are planned to be launched in economic development zones in Beijing or Shanghai. The First United AMC, founded by Huarong and a Morgan Stanley-led investment banking group will be responsible for resolving four packages of NPLs amounting to RMB10.8 billion (or USD1.30 billion), which covers problem loans in 254 companies in 18 provinces. The Rongsheng AMC will be launched by Huarong and Goldman Sachs and in charge of a package of RMB1.97 billion NPLs (or USD238.2 million) made to 44 enterprises in 13 provinces. *Huarong AMC Teams With Foreign Giants to Dispose of NPLs*, BUS. DAILY UPDATE, Dec. 10, 2002, *available at* LEXIS News [hereinafter *Teams with Foreign Giants*].

partners,[83] who paid nine cents on the dollar to Huarong,[84] are able to take controlling stakes.[85] According to a profit sharing plan, the income received by the partners from the follow-up disposals will differ at various stages. If recovery goes extremely well, Huarong could recoup as high as 21% of the portfolio's face value.[86] Significantly, this deal tested the Chinese government's willingness to comply with the international valuation practice, as there was a longtime concern within the government that selling NPLs at a large discount to foreigners amounted to stripping state assets.[87] The official approval of this transaction evidenced that "pragmatism on pricing the debts ha[d] won the day."[88] As outside observers hoped, with more international exposure, China's NPL market would become better regulated and more transparent.[89] In addition, incoming foreign participants would also bring to China their proven techniques of distressed debt resolution, such as asset securitization discussed below.

III. OVERVIEW OF ASSET SECURITIZATION

Subpart A reviews the background of asset securitization. Subpart B then compares the benefits of securitization with its costs.

A. Background of Securitization

Securitization is a financial innovation that transforms illiquid income-generating assets into securities with a second mar-

83. Four of the five blocks of NPLs were bought by a consortium including Morgan Stanley, Lehman Brothers, Salomon Smith Barney and KTH Investments, Goldman Sachs bid for another block. *Id.*

84. *Id.*

85. *Id.*

86. *See* Restall, *supra* note 52. In line with international practice, two disposal service firms will also be established to deal with the NPL disposal on behalf of the two joint ventures. The business scope of the two ventures includes NPL management, transfer, exchange, sale and restructuring, as well as debt collection, but no DESs, or direct investment services and other financial services, such as lending or deposits and settlement, are permitted. *Teams with Foreign Giants*, *supra* note 82.

87. Kynge, *supra* note 81.

88. Restall, *surpra* note 52.

89. *Foreign Capital Allowed, supra* note 82.

ket.[90] In a typical securitization transaction, an originator company effects a "true sale" of its rights in receivables or other financial assets to a special purpose vehicle, which then issues securities backed by the transferred assets.[91] Investors in the capital markets then purchase these securities at prices based on the ABSs' credit rating.[92] The SPV uses the ABS issuance proceeds to pay for the financial assets.[93] Sometimes mechanisms of credit enhancement such as letters of credit, third party guarantees, or over-colleteralization are employed to provide investors with additional protections against the risk of default payment.[94] In many cases, the originator also acts as servicer for the underlying assets, given its collecting expertise.[95]

Securitization first appeared in the 1970s, when the U.S. government took the initiative to develop a secondary market for residential mortgage loans.[96] Over the next three decades, the scope of securitization greatly expanded to encompass a wide range of assets, including student loans, credit card loans, automobile loans, airplane leases, commercial and recreational equipment leases and loans, health care receivables, music royalty receivables, and non-performing loans.[97] According to the U.S. Securities and Exchange Commission, securitization has

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90. Joseph Shenker & Anthony Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1371–74 (1991).

91. A true sale is a complete divestiture of ownership — the transferor no longer retains any right, title or interest in the property. It is intended to have the effect of removing the assets transferred from the transferor's estate under section 541 of the U.S. Bankruptcy Code. Therefore, an important feature of an SPV is its bankruptcy-remoteness. The Comm. on Bankr. and Corp. Reorganization of the Ass'n of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 541 [hereinafter *Structured Financing Techniques*]. To gain a general understanding of true sale and the related issue of bankruptcy remoteness, see SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, Chs. 3 & 4.

92. Schwarcz, *Alchemy*, *supra* note 7, at 136 (describing securitization as a process whereby a company uses an SPV to "raise[] funds by issuing securities, — usually debt or debt-like securities — and [then uses] the receivables purchased the originator to repay investors in the future").

93. *Id.*

94. *Id.*

95. *See* GIDDY, *supra* note 12, at 2.

96. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1-7 to 1-8.

97. *Structured Financing Techniques, supra* note 91, at 539.

become "one of the dominant means of capital formation in the United States."[98]

B. Benefits and Costs of Securitization

Some commentators view securitization as a sort of "alchemy" that benefits both the investors and originator.[99] For investors, securitization provides an opportunity to invest in diversified portfolio while undertaking a comparably low risk thanks to credit enhancements.[100] Furthermore, the transaction structure can be flexibly designed to accommodate the needs of investors with different or unique investment preferences.[101]

Reducing financing costs constitutes one of the primary benefits for an originator.[102] In a securitization transaction, the interest rate paid to the ABS investors is less than that paid in a straight debt issuance or equity offering by the originator.[103] This is possible because the return that ABS investors demand in a given deal is a function of only the credit rating of the securities backed by transferred assets.[104] As a result, the originator's creditworthiness is not a concern to the ABS investors.[105] A high ABS credit rating can thus be achieved because of the SPV's isolated credit risk, as well as a careful structural design

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98. Investment Company Act Release No. 19,105, [1992 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 85,062, at 83,500 (Nov. 19, 1992).

99. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1-2. Schwarcz argued that securitization is not a zero-sum game, in the sense that the originator's benefits do not merely offset another person's loss. He believed that securitization creates a genuine cost reduction for all parties. *See id.* at App. A: *Is Securitization A Zero-Sum Game? See also*, Frederick Feldkamp, *Asset Securitization, The Alchemist's Dream*, in SECURITIZATION YEARBOOK 2000 1 (supplement to INT'L FIN. L. REV., Oct. 2000); Shenker & Colletta, *supra* note 90; Howard Felson, *Closing the Book on Jusen: An Account of the Bad Loan Crisis and a Chapter for Securitization in Japan*, 47 DUKE L. J. 567, 587 (1997).

100. *See* GIDDY, *supra* note 12, at 2–3.

101. *Id.* at 3–4.

102. *Structured Financing Techniques*, *supra* note 91, at 530–31.

103. SHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1–9.

104. *Id.* The most accepted rating agencies are Standard & Poor's Rating Group ("S&P") and Moody's Investors Service, Inc. ("Moody's"). Another well-known agency is Fitch, Inc. For a general discussion on rating in securitization, see section 8:9 of SCHWARCZ, STRUCTURED FINANCE, *supra* note 7. *See also* Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV 1 (2002) [hereinafter *Rating Agency Paradox*].

105. *Id.*

and credit enhancements.[106] Accordingly, an originator who is unrated or rated below investment grade can nonetheless through an SPV issue ABSs with an investment grade rating.[107] Even for an originator that itself has an investment grade rating, cost savings may be achieved in securitization if the SPV can issue ABSs with an even higher rating.

Another advantage is that the originator can attract broader range of investors through a flexible transactional structure.[108] A creative deal designer may effectively utilize over-collateralization, revolving asset pools, or subordinated interests to reconstructed ABS cash flows and maturity feature, in order to cater to both risk averse and risk seeking investors.[109] The resultant wider market reach may then transform into higher demand for and better liquidity of the ABSs.[110]

Securitization transactions, however, incur substantial transaction costs. There are, for example, costly fees payable to the credit rating agencies, attorneys, investment bankers, and accountants.[111] Credit enhancement fees, annual reporting and printing fees also add to the long list of expenses.[112] Accordingly, some commentators argue that unless funds raised in a transaction exceed USD50 million, the benefits can hardly justify the extremely high transaction costs.[113]

In general, an originator will need to weigh potential cost savings against the transaction costs before launching a securitization transaction.[114] In other words, a company contemplating securitization should compare the expected differential between interest payable on alternative funding options and that on ABSs issued by an applicable SPV, with the expected difference in transaction costs between the alternative financing.[115]

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106. *Structured Financing Techniques*, *supra* note 91, at 533–34.
107. *Id.*
108. *Structured Financing Techniques*, *supra* note 91, at 531.
109. *Id.*
110. The availability of funds in developed markets is usually not as limited as in the private markets, and certain issues presented in the private markets, such as lending limits of a particular financing institution, do not exist in the capital markets. *Id.*
111. *See* Felson, *supra* note 99, at 589.
112. *Id.* at 599.
113. *Id.* at 587.
114. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 1–11.
115. *Id.*

IV. SECURITIZATION OF DISTRESSED LOANS

Subpart A discusses the desirability of distressed loan securitization from both the originator and investors' perspectives. Subpart B then considers four factors important to the feasibility of distressed loan securitization. Subpart C studies the RTC securitization program.

A. *Desirability of Distressed Loan securitization*

Generally, the business of securitizing distressed loans[116] becomes more attractive when lending banks see a rise in corporate defaults within their portfolios, and therefore the banks become concerned with their financial performances negatively affected by the increasing number of problematic loans.[117] From the viewpoint of financial institutions, the usual suppliers of securities backed by distressed loans, securitization limits their exposure to further losses to the extent of any guarantee or credit enhancement they provide to the transaction.[118] At the same time, the risks and rewards of the underlying problem loans are transferred to and spread among market participants.[119]

From the investors' perspective, securities backed by distressed loans can provide profitable investment opportunities as long as the capital returns exceed the undertaken risks.[120] In a distressed loan securitization transaction, investors expect that either the asset pool or the recoveries from loan collateral can

116. A loan is deemed distressed when the borrower's financial ability to honor its payment obligation comes into question. Common indicators of a borrower's financial difficulty include a breach of financial covenants, a payment or technical default of other debt obligations, or a trading value for their debt significantly below other debts with similar coupon and maturity features. Not all distressed debts are in default. The distressed debt of an issuer may be current on its bank loan obligations, but in technical or financial default on its other subordinated debt. However, in this situation, there is substantial near-term risk that the borrower will eventually default on its loan obligations. *See* Henry Albulescu et al., *Distressed Debts CDOs Spinning Straw into Gold*, S&P (May 7, 2001), *available at* http://www.standardandpoors.com > "fixed income" > "credit ratings criteria" [hereinafter [*S&P Criteria*].

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.*

provide sufficient value to compensate their investment.[121] To attract investors with different risk appetites, an originator may structure the transaction in a way that the same asset pool to generate several classes of notes with hierarchical seniority and different credit ratings.[122]

In determining the proper interest rates payable to investors, the ABS credit ratings assigned by credit rating agencies are crucial. These agencies serve the public investors' information needs by inquiring and analyzing the key features of a securitization transaction.[123] For example, Standard & Poor's considers a number of factors in rating a distressed loan securitization transaction originated by a financial institution: (1) quantitative and qualitative characteristics of the obligor's credit worthiness; (2) recoveries; (3) quantification of liquidity needs; (4) cash flow defaults and recoveries; (5) structural considerations; (8) collateral manager capability; and (7) legal analysis.[124]

B. *Feasibility of Distressed Loan Securitization*

At the heart of securitization is that asset pools must be able to generate reasonably predictable cash flows to pay ABS investors interest and principal.[125] Four factors are specifically important in determining the securitizability of distressed loans: (1) the nature of the obligors; (2) the recovery rates of the distressed loans; (3) the quality of the originator-servicer; and (4) the availability of liquidity facility and credit enhancement.

First, whether distressed loans are suitable for securitization heavily depends on the nature of loan obligors.[126] As commentators point out, the primary threats to steady ABS cash flows are the risks of obligors' slow payment or no payment.[127] To offset these risks, the asset pool created should satisfy three requirements: (1) the loan portfolio must consist of a sufficiently

121. *Id.*

122. *Id.*

123. *See Rating Agency Paradox, supra* note 105, at 10.

124. *S & P Criteria*, *supra* note 116, at "Overview of Standard USD Poor's Methodology."

125. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 2-1.

126. *Id.* at 1-1

127. The slow-payment risk is that the obligor on the loans may delay in making their payments, thus creating liquidity problem for the SPV. The no-pay risk is that the obligators may default in making their payments. *Id.* at 2-2.

large number of obligors in order to allow a statistical determination of the default risk;[128] (2) the loan concentration ratios should be sufficiently low in order to avoid the possibility that default by a relatively small number of obligors disproportionately harms the overall portfolio performance;[129] (3) ideally, the loans have homogeneous contractual terms, delinquency and loss experience in order to minimize the costs incurred in obtaining and analyzing information on the portfolio. If these criteria are met, it is possible to employ an actuarial analysis on expected losses, uniform underwriting standards and servicing procedures that are satisfactory to rating agencies and investors.[130] These three requirements explain why the paradigmatic securitizable assets are mortgage loans, auto loans, or bank credit card receivables. When a specific asset pool fails to meet all of the requirements, success of the transaction will require using credit enhancements to mitigate the risks.[131]

Second, recovery records serve as a crucial performance variable in distressed loan securitization.[132] By definition, distressed loans already have high delinquency and default risks. In securitization of such assets, therefore, the recovery ratio becomes a more meaningful consideration than default risk.[133] Recoveries may come from refinancing, restructuring or liquidation.[134] As long as recoveries produce a cash flow with relative predictability, the securities backed by distressed loans can also receive high credit rating, which may be further improved through credit enhancement. Factors relevant to such recoveries include the characteristics of coupons, collateral type, and origination date.[135] For example, if the loan is collateralized by assets with high liquidity value, such as tradable securities or real property at a good location, then the recovery ratio is likely to be high.

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128. *Id.*

129. This term refers to a situation where a relatively small number of the obligors account for a disproportionately large amount of loan portfolios. *Id.* at 2-2 to 2-3.

130. Shenker & Colletta, *supra* note 90, at 1377.

131. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 2-2.

132. *S & P Criteria*, *supra* note 116, at "Recoveries."

133. *Id.*

134. *Id.*

135. *Id.*

Third, the originator-servicer (usually a financial institution) plays a key role in a distressed loan securitization.[136] After all, the originator is the entity responsible for creating the asset pool from a suitable portfolio.[137] In addition, investors also rely heavily on the originator to channel the cash flow generated from the asset pool to the SPV for interest distribution.[138] Furthermore, the originator often assumes the servicer's role given its experience and skills in collecting debts and enforcing creditor's rights. In the event of loan defaults, the originator should take the best course of action to maximize recoveries for the investors' benefit.[139] In servicing securities backed by distressed loans, the originator's main task is not one of selecting and monitoring loans that are expected to be performing.[140] Rather, the focus is on choosing weak loans with good recovery prospects and on actively working with the defaulted borrowers, the lending group, bankruptcy courts, and any other parties in order to generate the necessary cash flow to service the required ABS payments.[141] To increase its ability to better service the asset pool(s), the originator may also transfers a part of servicing function to a reliable outside specialist.[142]

Finally, liquidity facility and credit enhancement mechanisms are often necessary to meet cash shortfalls and to raise ABS credit rating to a desirable level. One great liquidity need stems from significant loan defaults and/or restructurings.[143] Defaults usually result in an immediate cessation of the borrowers' promised loan payments.[144] In addition, restructuring and bankruptcy by one obligor may cause a write-down or extension of an original loan contract in order to alleviate the debtor's financial burden.[145] When any of these events happen, it becomes less certain when obligors' repayments under loan

136. Felson, *supra* note 99, at 603.
137. *S &P Criteria*, *supra* note 116.
138. Felson, *supra* note 99, at 603.
139. *S &P Criteria*, *supra* note 116.
140. *Id.*
141. *Id.*
142. Felson, *supra* note 99, at 604.
143. *S&P Criteria*, *supra* note 116.
144. *Id.*
145. *Id.*

contracts can be collected to service the ABSs.[146] Other than the liquidity problems caused by obligors, there are also cash needs to pay periodic transactional fees,[147] such as fees for servicer, trustee, accountants, legal experts and financial advisors.[148] Given the magnitude of liquidity problems in distressed loan securitization, therefore, it is necessary to create significant reserve accounts filling cash shortfalls.[149]

Credit enhancement mechanisms are also necessary to mitigate the problem of low repayment predictability and to raise the credit ratings of securities backed by distressed loans.[150] External credit enhancement can take different forms, such as a guaranty or surety bond, a bank letter of credit, an irrevocable credit line, or cash collateral account.[151] There are two common types of internal credit enhancement used in distressed loan securitization. One is over-collateralization, which means the anticipated cash flow from the underlying assets exceeds the scheduled principal and interest payments.[152] This arrangement helps to assure that a sufficient cash cushion exists to meet repayment obligations. The second one is senior-subordinate structure,[153] in which sophisticated investors willing to take a high level of risk would purchase subordinated securities, effectively providing another assurance for the SPV's senior securities bought by average investors.[154]

C. The RTC Securitization Program

The first securitization of non-performing loans in the U.S. history was the "N" series program by the Resolution Trust

146. *Id.* Additional liquidity problems can arise with revolving loans. When distressed revolving bank loans are sold to the SPV, both the right to receiving borrower payments and the obligation to fund borrower draws are transferred to securitization. However, the terms of most revolving facilities loan allow the lenders to suspend borrower draws if there is any significant deterioration or material change in the borrower's financial condition. Therefore, the corresponding liquidity needs may be less of a concern. *Id.*

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 2-16 to 2-17.

152. GIDDY, *supra* note 12, at 11.

153. SCHWARCZ, STRUCTURED FINANCE, *supra* note 7, at 2-17 to 2-18.

154. The interest rate on these subordinated securities would be higher than that on the senior securities to compensate for the greater risk. *Id.*

Corporation ("RTC") in the early to mid 1990s.[155] Congress created RTC as a major effort to manage and resolve the assets of failed savings and loan associations.[156] In its six years of existence, the RTC resolved 747 insolvent thrifts and recovered USD395 billion of the USD456 billion in its charge.[157] Heralded by observers as an outstanding success, the RTC employed many innovative strategies to promptly dispose of portfolios under its mandate.[158] The options RTC used varied depending on the quality and nature of the assets involved. High liquid assets, such as government securities, single-family mortgage-backed bonds, and high-yield bonds were disposed of without much difficulty in the well-developed secondary markets.[159] For lower quality assets such as non-performing mortgages, the RTC employed three major techniques: bulk sales, auctions, and mortgage securitization.[160]

The RTC's securitization model for mortgage-backed securities presented several features. First, the RTC issued securities in registered offerings.[161] The disclosure requirements of regis-

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155. *See* Jack Rodman, *Asia's Budding Revival*, 60 MORTGAGE BANKING 3640 (2000).

156. *See* Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, § 501, 103 Stat. 183, 184 (codified as amended at scattered sections of 12 U.S.C.).

157. *See* Dean Foust, *The RTC's Epitaph: It Worked*, BUS. WK., Jan. 15, 1996, at 29; Alvin K. Lim, *The S&L Crisis Revisited: Exporting An American Model to Resolve Thailand's Banking Problems*, 9 DUKE J. COMP. & INT'L L. 343, 355–56 (1998).

158. *See* Foust, *supra* note 157. The RTC achieved impressive performances, evidencing by the fact that the taxpayers' burden for the clean-up was only under USD145 billion, much less than many experts had predicted, the agency also received various critics. *See* Lim, *supra* note 157, at 355–56. However, it was charged with mismanagement, including the excessive use of expensive consultants as well as outright fraudulent billing by contractors, as well as hastily unloading its assets at bargain prices to the benefit of wealthy investors and detriment of taxpayers. *See id.* Nevertheless, "the general consensus is that the RTC was a rare example of a government agency that operated efficiently and effectively." *Id.*

159. *See* Lim, *supra* note 157, at 357.

160. *Id.*

161. *Id.* at 359. The RTC initially filed a USD4 billion shelf registration with the SEC in May 1991 to securitize single and multi-family mortgage loans. It subsequently filed more registrations to accommodate additional transactions in single and multi family loans, as well as commercial mortgage loans. *See also* Kenneth J. Bacon, Director of RTC Office of Securitization,

tration allowed investors to access material information regarding the underlying mortgages' risks, thus increasing public interest in the issuance and resulting liquidity of the securities.[162] In addition, the assets underlying the securities were typically held in trusts, which further reassured investors that the asset pools would be under unitary management.[163] Furthermore, credit enhancements, such as reserve funds, were used to obtain sufficiently high investment ratings in order to entice institutional investors.[164] Finally, to handle non-residential commercial mortgages in the pool that became non-performing, a "special servicer" was established to review the cases and take all necessary measures to minimize losses. [165]

Under the N-series program created specifically for securitization of sub- and non-performing mortgage loans, the RTC required interested commercial mortgage bankers to align with equity investors to purchase about half of any loan portfolio, while the RTC retained the remaining portion as a passive partner.[166] The first deal of N series, N-1, closed in December 1992.[167] This deal acquired USD350 million in book value of non- and sub-performing loans from the RTC.[168] The RTC, as a partner in the fund, leveraged the portfolio with USD110 million of debt raised by Lehman Brothers, and then sold a 50% equity interest in the remaining cash flows to Bankers Trust and Soros Realty for an undisclosed sum.[169] The RTC's NPL securitizaiton program was successful partially because the agency worked closely with the private sector in market development.[170] Usually, private institutional investors participated

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Securitization at the RTC, NAT'L MORTGAGE NEWS, Apr. 12, 1993, at 4, *available at* LEXIS News.

162. *See* Lim, *supra* note 157, at 359.

163. *Id.*

164. *Id.* Reserve fund levels were approximately four to seven times the expected losses on the total amount of assets the RTC securitized. The reserve funds were held by a trust and funded from bond proceeds. Bacon, *supra* note 161.

165. *See* Lim, *supra* note 157, at 360.

166. *Commercial MBs Can Service RTC CRE*, NAT'L MORTGAGE NEWS, March 1, 1993, at 13, *available at* LEXIS News.

167. Marlene Givant Star, *RTC Courts Pension Fund Assets*, PENSIONS & INVESTMENTS, March 22, 1993, at 35, *available at* LEXIS News.

168. *Id.*

169. *Id.*

170. *See* Bacon, *supra* note 161.

in the transactions in teams composed of asset managers, distressed loan servicers, and underwriters. These teams could then capitalize on their expertise in NPLs and structured finance, and make use of their access to capital markets.

V. SECURITIZATION DEVELOPMENT IN EAST ASIA

This Part examines the securitization experience of Japan, Korea and Taiwan, with an emphasis on their legal and regulatory development facilitating local market securitization.

As a sophisticated financial innovation, securitization has witnessed phenomenal successes in the U.S. and United Kingdom. This phenomenon perhaps surprises no one as these two countries enjoy the benefits that come along with a flexible common law system and highly developed financial markets. While many other countries also seek to develop similar programs in their own markets,[171] they come to realize the necessity and importance of establishing not only supportive capital markets but also adequate legal and regulatory infrastructures.[172]

To many Asian countries, their civil code systems present obstacles for carrying out securitization comprehensively. One commentator remarks on this difficulty:

> [T]raditional asset securitization structures cannot simply be "parachuted" into individual financial systems (especially those of emerging market economies with a civil law tradition) and expected to fulfill the sorts of functions for which they are so useful in the United States and the United Kingdom.[173]

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171. For example, France and Spain have successfully completed securitization transactions, Germany and Italy have passed legislation to promote securitization. *See generally,* ASSET-BACKED SECURITIZATION IN EUROPE (Theodor Baums & Eddy Wymeersch eds., 1996).

172. *See* Douglas Arner, *Emerging Market Economies And Government Promotion of Securitization*, 12 DUKE J. COMP. & INT'L L. 505, 506 (2002) (outlining for an emerging economy the requisite capital market and legal factors necessary for mortgage securitization).

173. Arner listed the following purposes that securitization may serve in the developed financial markets of the U.S. and U.K.: (1) supporting public policy objectives such as broad home ownership and the development of financial markets (especially capital and mortgage markets); (2) addressing regulatory requirements for financial institutions, especially capital adequacy and lending limit requirements applicable to banks; (3) transferring risk, especially in the context of non-performing assets and portfolio diversification; and (4) providing finance. *See id.* at 505. In addition, Feldkamp argued that properly

> Nonetheless, undertaking an asset securitization transaction in any given jurisdiction serves as a useful "stress test" of the limits in that specific jurisdiction, especially in respect to legal impediments.[174]

Although the inflexibility of civil legal systems makes it difficult to accommodate various securitization structures,[175] East Asia's great need for new capitals, especially after the financial crisis of late 1990s, has spurred exportation of this financial technology into the region.[176] With governmental support, several Asian economies have actively modified their individual legal and regulatory frameworks by implementing new legislation.[177]

Japan is the first Asian country that experimented with securitization. In the late 1980s and early 1990s, several Japanese government charged committees and organizations started to explore this financial tool.[178] In 1993, the Japanese Diet (the parliament) enacted the Law Regarding Regulation of the Business Concerning Specified Claims ("Specified Claims Law"), which permitted limited securitization of leases and credit card claims.[179] This legislation provided the impetus for the first securitizations backed by assets, such as auto loans and industrial and computer lease receivables.[180] In 1995, the Ministry of Finance proposed a liberalization of the financial markets to permit financial institutions and certain credit corporations to issue ABSs through domestic special purpose corporations.[181] The Japanese "Big Bang" initiated in 1996 set prompt resolu-

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implemented securitization could prevent or cure "liquidity traps," the "ultimate bad consequence of flawed economic and financial management policies" in the U.S. *See* Feldkamp, *supra* note 99, at 1.

174. *Arner, supra* note 173, at 506.

175. Kevin T.S. Kong, *Prospects For Asset Securitization Within China's Legal Framework: the Two-Tiered Model*, 32 CORNELL INT'L L.J. 237, 244 (1998).

176. *Id.*

177. For example, Indonesia enacted the Mortgage on Land and Land-Related Objects Law to facilitate secured lending based on land assets. Thailand introduced implementing legislation to create insolvency and trustee laws similar to the U.S. legal structure. *Id.*

178. Felson, *supra* note 99, at 591.

179. *Id.*

180. *Id.*

181. *Id.*

tion of the NPLs as a top priority for banking liberalization.[182] In a landmark transaction of 1999, Morgan Stanley Dean Witter sold the first securities backed by Japanese NPLs on a mix consisting of office, retail and apartment buildings.[183]

The Japanese legal and regulatory framework relevant to securitization went through considerable changes in the 1990s.[184] The developments in four legal areas are most significant. First, the burdensome perfection procedure imposed by the Japanese Civil Code[185] was streamlined through the passage of so called MITI Securitization Law of 1993[186] and more significantly the 1998 Perfection law.[187] Under the new perfection system, assignments of large numbers of financial assets can be perfected easily through a one-time filing.[188] Second, the Law

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182. *Id.*

183. Rodman, *supra* note 155.

184. For a discussion on the legal obstacles to securitization that Japan faced before the major framework modification was completed, see Hideki Kanda, *Securitization in Japan*, 8 DUKE J. COMP. & INT'L L. 359 (1998) (identifying three major obstacles: first, the compliance with the perfection requirements in connection with an asset transfer was costly and cumbersome; second, Japanese corporate law made it expensive to set up a special purpose entity; third, the regulatory structure of securities was complex and inflexible due to the long history of jurisdictional struggles among ministries involved).

185. Under the article 467 of Japanese Civil Code, to perfect the assignment of a contractual right, including receivables with respect to interested third parties, the assignor must either deliver proper notice or obtain necessary consent. In either case, the assignor is required to ensure that the relevant documents bear officially certified dates. *See* Masaru Ono, *Unique Aspects of Japanese Securitization Relating To The Assignment of Financial* Assets, 12 DUKE J. COMP. & INT'L L. 469, 472 (2002). *See also*, Yoshiki Shimada & Shinji Itoh, *Japanese Asset Securitization: A Guide For Practitioners*, 38 HARV. INT'L L. J. 171, 179–180 (1997).

186. TOKUTEI SAIKENTO NI KAKARU JIGYO NO KISEI NI KANSURU HORITSU [Law concerning the restrictions of business relating to specified claims, etc.], Law No. 77 of 1992. This law is commonly named after its main sponsor, the Ministry of International Trade and Industry ("MITI"). This law covers only specific types of financial assets, mainly auto loans and lease receivables. It is less often used since the passage of the Perfection Law.

187. SAIKEN JOTO NO TAIKO YOKEN NI KANSURU MINPO NO TOKUREITO NI KANSURU HORITSU [Law prescribing exceptions, etc., to the civil cod requirements for setting up against a third party to an assignment of claims], Law No. 104 of 1998. This law has a broader coverage. It allows general companies to perfect the assignment of monetary claims in relation to third parties through filing a simple electronic registration with the Legal Affairs Office of the Japanese government. *See* Ono, *supra* note 184, at 472.

188. *Id.*

Concerning the Securitization of Specified Assets by Special Purpose Companies ("SPC law") was passed and subsequently amended to reduce the cost of the establishment and operation of special purpose vehicles.[189] Third, in 1998, Japan amended the Foreign Exchange and Foreign Trade Law to facilitate cross-border transactions. The amended law eliminated licensing and prior notification requirements previously imposed on any transfer of receivables between Japanese residents and foreigners.[190] Finally, Japan enacted a new "servicer" statute to allow corporations to engage in the business of servicing NPLs originated by financial institutions.[191] This enactment has invited major foreign players to establish special-purpose corporations to service NPLs, providing comfort among the international investors interested in acquiring such assets in Japan.[192]

Securitization also made substantial inroads in other East Asian countries in the late 1990s when the region was struggling with the aftermath of a major economic and financial breakdown. In Korea, before the Act on Asset-backed Securitization ("Korean ABS Act") was enacted in 1998, securitization was difficult, if not impossible.[193] The Korean ABS Act became the cornerstone of the rapidly developing securitization in Korea.[194] A major purpose of this act was to improve the soundness of financial institutions.[195] This act greatly facilitated Ko-

189. The SPC law became effective on September 1, 1998 and was amended in 2000. Among other things, the amendment reduced the SPC's minimum capital, registration and license tax and the real property acquisition tax. The new law also broadened the scope of specific assets that may be securitized by an SPC to include general proprietary rights, in addition to loans extended by financial institutions, nominative monetary credits, real estate and beneficial interest of the trust holding such assets. *See Japan: Amendment to Promote Securitization*, 19 INT'L FIN. L. REV. 48 (2000).

190. *Id.*

191. *See* Yoshiki Shimad & Togo Dowaki, *Japan*, in 17 INT'L FIN. L. REV. 40 (1998).

192. Rodman, *supra* note 155.

193. Sean Bulmer & Hyoung Don Kim, *Korea,* in SECURITIZATION YEARBOOK 2000 28 (supplement to INT'L. FIN. L. REV., Oct. 2000).

194. *Id.*

195. The Act on Asset Backed Securitization, art.1 [hereinafter Korean ABS Act].

rea's NPL resolution and contributed to the successful restructuring of the country's financial system.[196]

The Korean ABS Act provides for the establishment of a bankruptcy-remote special purpose company ("SPC")[197] and the appointment of a qualified service provider to manage the assets.[198] It also sets forth certain conditions, which if satisfied assure a transfer of assets to be a true sale rather than a secured financing.[199] The Act further requires registration of a securitization plan, which contains certain information regarding the transferred assets, originator and securities issued.[200] The registration of assets transfer can be accomplished through a filing with the Financial Supervisory Committee.[201] In addition, securitization enjoys certain tax benefits, including a 50 percent reduction in capital gains taxes for the sale of real properties by the SPC, and an exemption of registration and acquisition taxes on real properties acquired by the SPC within a certain period of time.[202]

The Korea Asset Management Corporation ("Kamco"), a government NPL resolution agency,[203] has achieved impressive per-

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196. South Korea emerged as the star performer among the Asian economies in financial reform. It leads the way of restoring banking industry to health. *Asian Banking 2000 Review*, *supra* note 26, at 45.

197. Korean ABS Act, ch. 3.

198. *Id.* art. 11.

199. *Id.* art. 13. It is rather special that this act details the specifics of true sale instead of leaving it to the discretion of the courts. *See* Jong-Goo Yi, *Trends and Issues in Securitization in Korea*, INT'L FIN. L. REV. 2425 (Apr. 1 2001), *available at* 2001 WL 15390492.

200. Korean ABS Act, arts. 3–4.

201. On completion of the transfer registration, the transfer of receivables will be deemed to have been perfected against third parties, which obviates the need to complete the normal perfection steps such as sending of notices with a fixed date stamp. If receivables are secured by mortgages, on registration of transfer of receivables with the FSC, the mortgages are deemed to have been transferred to the SPC. Therefore, the normal steps to register the transfer of mortgages with the relevant real property registration office are not necessary. *Id*, arts. 6–8.

202. *See* Yi, *supra* note 199.

203. Kamco is the only institution in Korea charged with this mandate. This mission is stated under the government Act on the Efficient Disposal of Bad Assets of Financial Institutions. Currently, 38% of Kamco's shares are directly owned by the Korean government, another 31% indirectly owned by the government through the Korea Development Bank, and the rest is owned by 24 Korean financial institutions. Of the NPLs acquired by Kamco, 63.19% were from commercial banks, 24.81% from investment trust companies, 7.97%

formance in utilizing securitization to resolve NPLs. From 1999 to 2001, Kamco successfully securitized USD5.9 billion of NPLs acquired from financial institutions.[204] Kamco made its first domestic public offering of NPL backed securities worth USD271 in June 1999.[205] Samsung Securities and Huyndai Securities bought the bonds and auctioned them off to local investors.[206] Kamco's first international NPL securitzation was accomplished in July 2000.[207] A dual SPV structure accomplished this transaction.[208] A Korean SPV sold a senior note backed by a NPL portfolio denominated in U.S. dollars and Japanese yen to a Cayman SPV.[209] Two credit enhancements were used for the Korean senior note: subordinated notes and irrevocable credit facility that the Korean Development Bank provided.[210] The Cayman SPV then issued USD367,000,000 floating rate notes due in 2009, secured by the issuer's interest in the Korean SPV senior note.[211] The Cayman SPV senior notes were rated at BBB and Baa2 by Fitch and Moody's respectively, and listed on the Luxemburg Stock Exchange.[212] The notes were then offered to qualified institutional buyers in the U.S. pursuant to Rule 144(a).[213]

Taiwan passed its Financial Assets Securitization Statute in 2002.[214] Modeled on the Japanese civil law approach, this legislation provides for Special Purpose Trusts ("SPTs") to securitize assets and issue beneficiary certificates backed by those as-

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from insurance companies and 3.61% from merchant banks. *See FQA,* at http://www.kamco.or.kr/eng/faq/faq1.htm (last visited Feb. 27, 2003).

204. *New Tack Eyed for Collection Agency*, NIKKEI WEEKLY (July 9, 2001), *available at* LEXIS News.

205. *Kamco "MIRAE" Bond 99-1*, at http://www.kamco.or.kr/eng/area/mirae/mirea99-1.htm (last visited Oct. 17, 2002) [hereinafter *Kamco "MIRAE" Bond 99-1*].

206. *Id.*

207. Sean Bulmer & Hyoung Don Kim, *Kamco NPL Securitization*, in SECURITIZATION YEARBOOK 2000 28, 29 (supplement to INT'L FIN. L. REV. (2000)) [hereinafter *Kamco NPL Securitization*].

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.*

214. Karen Richardson, *Taiwan's Tough Stance on Banks Lures Investors*, WALL ST. J., Dec. 18, 2002, at C14.

sets.[215] It also sets out the types of financial assets that may be securitized.[216] The act permits financial institutions to pool home mortgages, credit-card receivables, or corporate loans — including non-performing loans — and then issue new debts backed by these assets.[217] In addition, borrowing the U.S. concept of "Ginnie Mae," the act allows Taiwanese government and financial institutions to establish a fund to promote securitization and guarantee creditworthiness.[218] Significantly, financial analysts view this legislation as a major component of Taiwan's comprehensive program to clean up its NPL laden banking industry.[219] Experience in several other Asian countries, including Thailand and the Philippines,[220] also demonstrated that during the time of financial turmoil, there tended to be a great demand for the restructuring of financial institutions with a large volume of non-performing assets. [221] Notably, the need to resolve NPLs, a prevalent problem in the region, served as a catalyst for securitization in East Asia.

VI. NPL SECURITIZATION IN CHINA: THE MARKET CONDITIONS

When acceded to the WTO in December 2001, China undertook to open its entire financial sector to foreign competition after five years. As time quickly goes by, the Chinese government sees the increasing exigency of overhauling its insolvent banking system. Promptly disposing of the daunting NPLs, therefore, tops China's financial restructuring agenda. Because of the U.S. and other Asian countries' successful experience, securitization began to attract attention in China as an alternative NPL resolution. The PBoC, a major Chinese financial regu-

215. Qi Lin International Law Offices, *Securitization Law Nears Passage* (Sept. 2001), *available at* http://www.securitization.net/pdf/qilin_cm_0901.pdf.

216. Taiwan' NPL ratio is estimated to range from 6.5 to 15% of all loans. Neil Campbell et al., *Securitisation Comes to Taiwan* (Oct. 2001), *available at* http:// www.securitization.net/pdf/qilin_sectai_1001.pdf.

217. Richardson, *supra* note 214.

218. Qi Lin, *supra* note 215.

219. *Id. See also* Campbell, *supra* note 216.

220. Richardson, *supra* note 214.

221. *See* Yi, *supra* note 199. In fact, Japan has recently realized that it has been slow in securitizing the distressed loans taken over by the Resolution and Collection Corporation, and that it should learn from the successful experience of the Korea Asset Management Corporation. *New Tack Eyed for Collection Agency*, NIKKEI WEEKLY, July 9, 2001, *available at* LEXIS News.

lator, has indicated its support for such an experiment.[222] Financial institutions, especially the AMCs mandated with NPL disposition, have been actively exploring this new option.[223]

A. Supply of NPL Securitization

The supply of NPL securitization in China can be understood from the four feasibility factors identified in Part IV.[224] The first factor affecting asset pool creation is the nature of obligors. Ideally, the underlying portfolio should feature with a statistically large number of obligors, low loan concentration ratios, and standardized or similar loan contractual terms.[225] In reality, however, the Chinese state banks have extended four fifths of their lending to SOEs, particularly favoring a targeted group consisting of the biggest ones, which the government deemed as pillars of the state sector.[226] Furthermore, because bank lending oftentimes provided the main source of working capitals for SOEs, loan agreements varied in their terms, depending upon the borrowers' business and financial conditions.[227] Unfortunately, a large number of SOEs do not generate enough operating revenues even before interest expenses were paid.[228] Many of them have no viable prospect of becoming profitable. They have not been liquidated due to the governmental concern that

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222. During the "China Development Summit Forum" held on March 25, 2001 in Beijing, Dai Xianglong, governor the Chinese Central Bank PBoC, stated that China would study the successful experiences of international asset management companies and experiment assets securitization as a way to dispose of NPLs. Dai also emphasized the possibility of using securitization as a means to introduce international capital and expertise into Chinese banking sector. *See Zhengquanhua: Huajie Buliang Zichan de Youxiao Tujing* (Securitization: An Effective Approach of Resolving NPLs), JINRONG LILUN YU SHIJIAN (FIN. THEORIES AND PRAC.) (Beijing, 2001).

223. Our analysis of the NPL securitization market below focuses on the portfolios transferred from the state banks to the AMCs for the reason that the AMCs are specifically set up by the government to deal with NPL resolution. Major references are made to the practices of Huarong, one of the biggest and most adventuring AMCs in China.

224. *See infra* Part IV.

225. *See infra* footnotes 126–154 and accompanying text.

226. *Casino Capital*, *supra* note 1, at 11.

227. *See* Dan Huang, *Woguo Tuixing Zichan Zhengquanhua de Zhang'ai Fenxi* (An analysis on the Obstacles to Asset Securitization in China) at 1 (on file with the author).

228. *See Pitfalls Ahead, supra* note 74.

an aggressive reform plan would produce vast social implications and even unrest.[229]

The foregoing analysis of the first factor establishes that a vast majority of NPLs under the Chinese AMCs management is not suitable for securitization. However, it is not true that NPLs securitization is completely impossible. An inquiry under the second factor, i.e. the recovery ratios, shows that among the massive portfolios of Chinese NPLs, three groups of NPLs seem to be potentially securitizable.

The first group is the non-performing commercial mortgages extended in the mid 1990s during economic overheating.[230] This type of NPL, although accounting for only a small percentage of the overall Chinese NPLs, is still sizable in absolute dollar amounts.[231] Recovering certain portion of such NPLs' value is viable given the rapid economic growth seen in the major Chinese cities, the locations of many the real estate projects involved in NPLs.[232]

In addition, non-performing corporate loans secured by land use rights or other real estate collateral are also potential securitization assets. However, cash flow generated through foreclosure and liquidation of NPL collateral must be reasonably predictable to support the ABS repayments.[233] This would rest on the enforceability of the AMCs' creditor rights and a functioning liquidation market. [234] However, China's current conditions with respect to both factors are yet to be further improved.

The last group of securitizable NPLs originates from loans rendered to SOEs with whom the AMCs are able to work out

229. *See Corporate/Debt Restructuring: Japan, The Hong Kong SAR & The People's Republic of China: A Roundtable Discussion*, 10 AM. BANKR. INST. L. REV. 1, 23 (2002) [hereinafter *Roundtable Discussion*]. *See generally,* LARDY, *supra* note 22, ch. 2 (*The State-Owned Enterprise Problem*).

230. *See supra* notes 46–47 and accompanying text.

231. Interview with Xiaobo Wang, General Manager of Huarong Research Department, in Beijing, China, (Jan. 9, 2003) [hereinafter Interview with Wang]. No published statistics on this category of NPLs are currently available.

232. *Cf.* Felson, *supra* note 99, at 609 (arguing that jusen (Japanese consumer mortgage loans) securitization could provide investors with a profitable opportunity when the real estate appreciates as a result of development programs and an overall growth in the Japanese economy).

233. *See* Xiaobo Wang, *Buliang Zichan Ye Keyi Zhengquanhua* (Non-Performing Loans Can Also be Securitized) (on file with the author).

234. Interview with Wang, *supra* note 231.

reliable repayment schedules. In fact, Kamco, the Korean counterpart of the Chinese AMCs, has successfully securitized certain distressed corporate loans transferred from financial institutions.[235] Significantly, Kamco securitized only "restructured corporate loans," i.e. loans that have obtained court approvals of restructuring as part of corporate re-organization or composition proceeding regardless of security existence.[236] The borrowers were private companies considered operationally viable with only temporary liquidity problems.[237] The asset pools, therefore, could generate predictable repayments based on court sanctioned restructuring schedules.[238] Among the Chinese AMCs' debtor SOEs, there exist a certain number of companies that have viable business prospect but incurred excessive debts. These companies are potentially able to pay off a portion, but not the whole, of their bank loans.[239] Effective debt restructuring with these SOE debtors, therefore, would recover a fraction of the NPL book value.[240] In fact, the Chinese government has provided the AMCs with an authority to partially forgive certain SOEs' debts and then work out the balance in new payment schedules.[241] For example, among Huarong's NPL recoveries, over 80% were accomplished through debt restructuring, with less than 20% stemming from liquidation.[242] To support securitization, however, the repayment stream under debt restructuring must be reasonably predictable. Absent the court

235. *See Kamco "MIRAE" Bond 99-1*, supra note 205.

236. Therefore, when Kamco initially purchased these loans, the original lenders were not entitled to declare default or execute their claims through the foreclosure. This was due to the current and existing repayments of the loans according to the rescheduled payment schedules. Thus, in valuing the restructured loans, more emphasis has been given to the credit standing of the borrowers. *Id.*

237. *Id.*

238. *Id.* In addition, when purchasing the NPLs from the Korean commercial banks Kamco retains a put option, which allows Kacmo to sell back the NPLs to the relevant banks on the occurrence of certain events such as payment default continuing for six months. *Id.*

239. Kaisheng Yang, Restructuring and Disposing of China's Financial Non-Performing Assets — A New Investment Trend in China, Address at Asia Society's Conference "Investing in China's Financial Market" (May, 2002) (on file with the author) [hereinafter Yang Speech].

240. *Id.*

241. The banks are however not permitted to reach such partial debt forgiveness agreements with their SOE debtors. *Id.*

242. *Id.*

sanction and monitoring that were available to Kamco, the Chinese AMCs will have to rely on the not very effective non-judicial methods to enforce their restructured payment plans.

The foregoing discussion indicates that the Chinese AMCs may create asset pools consisting of certain securitizable NPLs.[243] In order to understand the technical aspects of securitization one must also consider the third and fourth feasibility elements.

The quality of servicer cannot be overestimated. To make a NPL securitization plan work, the originator-servicer, which in this note's analysis would be one of the Chinese AMCs, must recover predictable cash flows either by actively working with the obligors, or by liquidating foreclosed loan collateral. The AMCs can be expected to well perform the originator-servicer functions given their full resolution power and expertise in debt collection and workout. In addition, the AMCs can further enhance their capability through strategic alliance with experienced international counterparts.[244]

The success of NPL securitization also requires the availability of liquidity arrangements and credit enhancements. Given the low predictability of NPL repayment cash flows and substantial liquidity risks, significant reserve accounts are usually indispensable to fill the cash shortfalls.[245] Furthermore, credit enhancements are also necessary in order to provide structural protection. In the case of Chinese NPL securitization, to raise the ABS credit rating to above investment grade, it is desirable

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243. Huarong seems to have completed its design of a pilot asset backed securitization scheme and the establishment of asset pools. It has submitted this plan to relevant financial regulators. CHINA HUARONG ASSET MANAGEMENT CORPORATION, OVERVIEW 2001, at 15 (on file with author). In fact, Huarong's first international NPL auction provides a good example of portfolio selection for the purpose of structuring a particular transaction. About 60% of the assets underlying the sold NPLs are in SOEs, with the remainder to commercial property, industrial parks, hotels, residential precincts, and a free trade zone. *See* Kynge, *supra* note 87.

244. For example, on April 26, 2001, Huarong entered with Kamco a memorandum inviting the latter to work as its advisor in securitization, and to assist Huarong select portfolios and design securities structure. *Huarong Invites Foreign Advisor for Asset-Based Securitization,* XIN HUA, April 26, 2001, *available at* LEXIS News.

245. Wang, *supra* note 233, at 3.

for the AMCs to provide guarantees and to use senior/subordinated structures.[246]

B. Demands for NPL Securitization

The demand for NPLs securitization cannot be analyzed without first understanding the general conditions of China's capital markets. Although the markets have achieved remarkable growth, they still have a long way to go before reaching a more mature stage. The following discussion highlights a few prominent market features.

First, expansions in primary equity market and that of primary debt market are not balanced, with the former far outstripping the latter. China's debt market mainly consists of treasury bonds.[247] In 1987, the Ministry of Finance issued the nation's first treasury bonds, and by 1998 total Treasury issues rose to about USD80 billion.[248] This increase resulted from the Chinese government's growing reliance on treasury issues to finance its fiscal deficits.[249] In contrast, the equity market has experienced a much more dramatic growth. China did not have a stock market until 1990, but now more than 1,200 stocks are listed on the Shanghai and Shenzhen stock exchanges, with a market capitalization of around USD500 billion, second in Asia only to Japan.[250] In addition, Chinese companies make up 35% of Hong Kong's stock market capitalization, against only 7% in 1995.[251]

In addition, the secondary market activities are significantly speculative. Price/earning ratios in China's stock market are not supported by fundamentals.[252] Individual investors, rather than institutional investors, dominate the nation's stock mar-

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246. *Id.*

247. Bob Yau-Ching Chan, *The Mortgage-Backed Securities Market in the People's Republic of China*, in MORTGAGE-BACKED SECURITIES MARKET IN ASIA 68–74 (1999), *available at* http://www.adb.org/Documents/Books/Mortgage_Backed_Securities_Markets.

248. ERNST & YOUNG REPORT, *supra* note 25, at 35.

249. *See* Chan, *supra* note 247, at 247

250. *Casino Capital*, *supra* note 1, at 10.

251. *Id.*

252. Chan, *supra* note 247, at 68.

ket.[253] These investors trade frequently on rumors, causing high market volatility.[254] In the secondary bond market institutional investors are the main players. They trade in large volumes but usually concentrate on a particular issue, and therefore making prices quite volatile.[255]

Furthermore, the access to capital markets is highly regulated. Under the current Company Law companies eligible for entering domestic bond market are only those which have generate profits in the past three consecutive years and where the average profits generated by such companies during such three-year period are enough to repay the companies' one year interest on the bonds to be issued.[256] In fact, the PBoC approved few corporate bonds were approved in recent years.[257] Similarly, new share listings on the stock market are subject to tight restrictions by the China Securities Regulatory Commission. The CSRC has been functioning as the "country's chief allocator of equity market," giving favor almost exclusively to SOEs.[258]

Finally, China's capital markets are still largely closed to foreign investors. Until very recently, the only onshore market available to foreigners was the foreign currency denominated B-share market, which is very small in capitalization (about 3% of that of the RMB denominated A-share market), and thinly traded.[259] With China's WTO admission, rules restricting foreign investment in domestic markets are being gradually eased. A major progress in market open-up was achieved in the end of year 2002, when the CSRC and PBoC jointly promulgated a new regulation allowing "qualified foreign institutional inves-

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253. There are about 66 million individual investors in the Chinese stock market, with 100-odd brokers, and 15 fund-management companies serving them. *Casino Capital, supra* note 1, at 10.

254. Chan, *supra* note 247, at 68.

255. *Id.*

256. ZHONGHUA RENMIN GONGHEGUO GONGSI FA (Company Law of the People's Republic of China) art. 159, *translated in* LEGISLATIVE AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONGRESS, THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1993, at 269–318 (1995).

257. Chan, *supra* note 247, at 69.

258. *Casino Capital*, *supra* note 1, at 11. S&P counts thiry-five "private" listed companies in China, but points out that local governments and even the military are in fact in control of a good number of them. *Id*.

259. *See* Ma, *supra* note 63.

tors" ("QFIIs") to invest in domestic equity and bond markets.[260] This partial market liberalization offers new opportunities for foreign investors to tap China's ever-growing domestic markets. However, due to the strict curbs on the amount of money QFIIs may invest and the length of time they can take the money out of China, so far only a handful of foreign financial institutions have expressed interest in apply for a QFII license.[261]

The foregoing overview of China's current capital markets demonstrates that much remains to be done to increase both market breadth and depth. Because of the novelty and complexity of securitization itself and the exotic nature of NPL securitization, there is a general lack of knowledge about the securitization concept and relevant principles. It is, therefore, not surprising to expect that the demand for NPL backed securities will be very limited. The participants in this market are likely to be confined to institutional investors, which in the domestic markets currently include commercial banks, insurance companies, pension funds, and fund management companies.[262] However, even the demand of these domestic institutional investors will be relatively small due to the few numbers of institutional players and their capital constraints.[263] In addition, many of these institutional investors are currently subject to strict limitations on their investment scope and can only invest in low-risk instruments, such as treasury bonds.[264] Another possibility of demand for the Chinese NPLs comes from outside of the country. Recently, some major international investors have exhibited a rising interest in the Asian NPL market.[265] These large global players have been quite successful in countries such as Japan, Korea and Thailand.[266] They now seem to be willing to shift part of their investment in the budding Chinese

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260. Provisional Measures on the Administration of Qualified Foreign Institutional Investors Investing in Domestic Securities (promulgated by CSRC & PBoC, Nov. 5, 2002), *available at* http://www.isinolaw.com.

261. *See China Limits Program on Foreign Investment*, ASIAN WALL ST. J., Dec. 2, 2002, at M2.

262. *See* Huang, *supra* note 227, at 2.

263. *Id.*

264. *See China State Banks to Receive Extra Help On Bad Loans*, CHINA DAILY, May 2, 1999, *available at* LEXIS News.

265. *See* Richardson, *supra* note 214.

266. *Id.*

NPL market.[267] However, as discussed below, international investors still hesitate to allot large amounts of money in the Chinese NPL market, mainly due to their concern with country's unsophisticated and opaque regulatory regime.

VII. NPL SECURITIZATION IN CHINA: LEGAL AND REGULATORY FRAMEWORK

This Part first outlines the existing legal and regulatory framework relevant to securitization, including laws governing the areas of company, trust, contract, secured transaction, and bankruptcy. It then identifies the current legal obstacles or legislative gaps impeding NPL securitization. In addition, this Part suggests enactment of special legislation to facilitate securitization.

China's legal system does not specifically provide for asset securitization as a financial technique. However, Chinese companies have already successfully completed a few international securitization transactions, which involved mainly future receivable cash flows of infrastructure projects[268] as well as future shipping receivables.[269] The following discussion outlines the legal framework within which a securitization transaction may be structured.

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267. *See China Seeks Foreign Capital To Help Manage Domestic NPAs*, ASIA PULSE, Jan. 2, 2003, *available at* LEXIS news (pointing out that regardless of their sizes, international funds begin to see a big potential for profits in China's NPL market). In addition to Huarong's recently approved international auction, China Construction Bank is also seeking governmental approval to form a joint venture with Morgan Stanley to resolve bad assets with a book value of about USD483 million. *China Bank Seeks Aid Abroad*, ASIAN WALL ST. J., Jan. 10–12, 2003, at M3.

268. For example, in August 1996, Zhuhai Express Way Company, acting as both originator and issuer, successfully completed a USD200 million bond offering. The bond placement was secured by fees the Zhuhai municipal government collected from toll roads, bridges, and tunnels, as well annual vehicle registration fees. *See Banks See ABS As New Finance Tool,* CHINA DAILY, March 3, 1998, at 6.

269. In April 1997, China Ocean Shipping Company, a state-owned shipping company, successfully securitied its future shipping revenues from its U.S. and European business. Kong, *supra* note 175, at 240.

A. Establishment of Domestic SPVs

Currently, Chinese law does not allow the establishment of a special purpose corporation used in securitization transactions of many other jurisdictions. The law presently permits Chinese companies only to conduct their businesses within the scope approved by the State Administration of Industry and Commerce ("SAIC").[270] This strict *ultra vires* restriction raises difficulties in establishing an SPC within China.[271] Given that SPC's purchase and sale of receivables are likely to be deemed as financial services, SAIC will unlikely to issue a business license to an SPC, which usually has thin capital.[272]

However, the 2001 enactment of Trust Law[273] makes it possible to use a special purpose trust to carry out securitization. Although passing the Trust Law is a major legislative achievement, the "trust" concept is still new to China, as is to many other civil law countries.[274] Therefore, it remains to be seen how the law will be applied and interpreted in the context of asset securitization. For example, one issue would be whether the beneficiary certificates issued by SPTs are considered securities.[275]

270. *See* Jonathan Zhifeng Zhou, *Launch of the Securitization Market in the PRC? Still a Long Way to Go,* in SECURITIZATION YEARBOOK 2000 18 (supplement to INT. FIN. L. REV., Oct. 2000). *See also*, Gao Peiji and Paul Kruger, *China Faces Up to the New Challenges of Securitization*, 19 INT'L FIN. L. REV. 29 (2000).

271. *See* Zhou, *supra* note 270.

272. *Id.*

273. ZHONGHUA REMIN GONGHEGUO XINTUO FA (Trust Law of the People's Republic of China), 9TH NAT'L PEOPLE'S CONG., 21ST SESS., STANDING COMM. (April 28, 2001), *available at* http://www.isinolaw.com. The Trust Law became effective on October 1, 2001.

274. *See* Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *New Developments in Structured Finance*, 56 BUS. LAW. 95, 128–129 (2000). [hereinafter *New Developments*].

275. Currently, China's Securities Law does not provide for ABS in the definition of securities. *Cf. Securitization Law Nears Passage, supra* note 215 (stating that under Taiwan's Financial Assets Securitization Statute beneficiary certificates issued by SPTs are classified as securities unless the Ministry of Finance determines them to be short-term bills).

B. Transfer of Receivables

Articles 79 to 81 of the new Contract Law effective on October 1, 1999 deal with transfer of receivables.[276] Under the new law, a creditor may, subject to limited exceptions, assign its contractual rights to a third party by serving a notice to the debtor of such an assignment without first obtaining consent from the debtor.[277] This legal allowance greatly facilitates a receivable transfer, which is a usual step in a securitization transaction.[278] Such assignment, however, must be approved or registered in accordance with any legal or regulatory relevant provisions if so required thereunder.[279] This requirement is significant to prospective NPL securitization, in which transfer of state-owned assets are most likely to be involved. Since changes in ownership of state assets and valuations thus involved are subject to complicated regulatory regime, NPL securitization may very well require special approval by relevant agencies.[280]

C. Secured Credit Law

China's Security Law passed in 1995 recognizes five types of security: guarantee, mortgage, pledge, lien, and deposit.[281] The law provides that buildings, land use rights, and movable property such as machinery may be mortgaged.[282] The law also contains provisions on mortgage registration and foreclosure.[283]

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276. ZHONGHUA RENMIN GONGHEGUO HETONG FA (Contract Law of the People's Republic of China), arts. 79–81, *translated in* LEGISLATIVE AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA, THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1999 9-76 (2000) [hereinafter CONTRACT LAW].

277. *Id.* art. 80. However, simultaneously transferring both the contractual rights and obligations still requires the consent by the counter-party. *Id.* art. 88.

278. *See* Gao & Kruger, *supra* note 270, at 29–30; *see also* Zhou, *supra* note 270, at 18.

279. CONTRACT LAW, art. 87. *See* Gao & Kruger, *supra* note 270, at 30.

280. *Id.* at 30–31.

281. ZHONGHUA RENMIN GONGHEGUO DANBAO FA (Security Law of the People's Republic of China) art. 2, 8TH NAT'L PEOPLE'S CONG., 14TH SESS., STANDING COMM. (Oct. 1, 1995), *reprinted and translated in* CHINA L. & PRAC. 21 (Aug. 1995) [hereinafter SECURITY LAW]. *See also* Kong, *supra* note 175, at 255.

282. SECURITY LAW art. 34. *See also* Jerome Cohen & John Lange, *The Chinese Legal System: A Primer For Investors*, 17 N.Y. L. SCH. J. INT'L & COMP. L. 345, 370–71 (1997).

283. SECURITY LAW arts 38-44, 53-58.

However, the lack of procedures on registration and foreclosure means that there is no effective protection against subsequent purchasers' claims absent notice of the security interest, and that no efficient means of executing against collateral exists in the event of a default on the underlying obligation.[284]

Provision of foreign-related security is subject to the Foreign Security Procedures promulgated by PBoC,[285] and Foreign Security Implementing Rules issued by Sate Administration of Foreign Exchange ("SAFE").[286] The Foreign Security Procedure recognizes only three forms of foreign-related security interest: guarantees, mortgages, and liens.[287] Under the Foreign Security Implementing Rules, any foreign-related security must obtain SAFE's prior approval.[288] Assignments of foreign-related security rights would require prior consent of the security provider as well as SAFE approval.[289]

D. Bankruptcy Law

Although Chinese bankruptcy law is fragmented[290] and under review,[291] general bankruptcy concepts are recognizable in the

284. Cohen & Lange, *supra* note 282, at 371.

285. Jingnei Jigou Duiwai Danbao Guanli Banfa [Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China Procedures] (Sept. 25, 1996), *reprinted and translated in* CHINA L. & PRAC. 37 (Mar. 1996) [hereinafter Foreign Security Procedure].

286. Jingnei Jigou Duiuwai Danbao Guanli Banfa Shishi Xize [Administration of the Provision of Security to Foreign Entities by Domestic Institutions Inside China Procedures Implementing Rules] (Jan. 12, 1998), *reprinted and translated in* CHINA L. & PRAC. 22 (Apr. 1998) [hereinafter Foreign Security Implementing Rules].

287. Foreign Security Procedures, *supra* note 285, art. 2.

288. Foreign Security Implementing Rules, *supra* note 286, art. 3.

289. *See* Kong, *supra* note 175, at 256.

290. On the national level, there is the Law of the People's Republic of China on Enterprise Bankruptcy (for Trial Implementation), the Company Law, which includes some bankruptcy-related provisions applicable to limited liability companies and joint stock companies, and the Code of Civil Procedure, which includes some bankruptcy-related provisions applicable to legal persons, including joint ventures and other foreign-invested enterprises. On the local level, there are some other regulations relating to bankruptcy and/or litigation. *See* Cohen & Lange, *supra* note 282, at 372.

291. It is expected that the long awaited, comprehensive new bankruptcy law will be promulgated in the near future. *Roundtable Discussion*, *supra* note 229, at 22.

existing regime.[292] Under the various bankruptcy-related laws, a creditor has the right to petition for a debtor's insolvency.[293] After the court's declaration of bankruptcy, a liquidation committee created by the People's court or a court has the power to invalidate transactions occurring six months prior to the date of the acceptance of bankruptcy proceedings by a Chinese court on certain grounds.[294] Secured creditors have priority rights in the property of an insolvent debtor, preempting any competing claims of unsecured creditors to the same debtor's assets.[295]

If the debtor is an SOE, the bankruptcy petition is currently subject to prior approval of relevant authorities.[296] There may be a two-year reorganization period initiated by authorities.[297] If the debtor still defaults on its debt payment upon expiration of reorganization, the court shall declare the debtor bankrupt.[298] While creditors do have the ability to petition for the insolvency of SOEs, for both practical and policy reasons, SOE bankruptcies have been allowed only on an experimental basis and in relatively limited numbers.[299]

E. Legislative Uncertainties

While structuring a securitization transaction within the present legal and regulatory framework is possible, significant gaps exist, presenting substantial uncertainties to the success of NPL securitization. First, although the Chinese laws appear to recognize the concepts of perfection and priority,[300] there is

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292. Gao & Kruger, *supra* note 270, at 33.

293. *Id.*

294. *Id.*

295. *Id.*

296. ZHONGHUA REMIN GONGHEGUO QIYE POCHAN FA (SHIXING CAOAN) (Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation) (Dec. 2, 1986), *translated in* LEGISLATIVE AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA, THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 684–95 (1998).

297. Gao & Kruger, *supra* note 270, at 33.

298. *See Roundtable Discussion*, *supra* note 229, at 15.

299. *See* Cohen & Lange, *supra* note 282, at 371.

300. "Perfection" refers to protection of a transferee's interest in transferred assets from creditors of the transferor and from the transferor's trustee in bankruptcy. In a securitization transaction, perfection means to protect the SPV's interest in the transferred financial assets from claims of the originator's creditors. *See* Steven L. Schwarcz, *The Universal Language of Cross-Border Finance*, 8 DUKE J. COMP. & INT'L L. 235, 240 (1998). In the U.S. arti-

no clear guidance on how to accomplish a valid portfolio transfer in securitization where usually numerous obligors are involved.[301] The Contract Law abolished the rule requiring a written agreement for a contract of any kind.[302] The law is silent, however, on whether notice of assignment to the debtor must be given in writing and when such notice may be deemed delivered to the obligors.[303]

Second, Chinese laws have yet to address the issue of a true sale.[304] Some uncertainty remains as to the treatment of recourse and the enforcement of a transferee's right.[305] It is unclear, for example, how the determination of a true sale would be affected when a transaction employs certain credit enhancement mechanisms, such as provision of a guarantee by the originator, or the existence of the originator's right to any surplus collections.

Third, China's existing legal system provides insufficient protection of creditors' rights. For example, the enforcement of

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cle 9 of U.C.C. provides that perfection is achieved by filing financing statements in jurisdictions where the debtor (originator) or the collateral is located.

"Priority" refers to the ranking of multiple claims to the same asset. In bankruptcy, it refers to "a creditor's right to have a claim paid before other creditors of the same debtor receive payment." BLACK'S LAW DICTIONARY 1212 (7th ed. 1999). Priority is ascertained by searching filing records to determine whether other parties have prior filings against the relevant collateral or assets. *See, e.g.,* U.C.C. § 9-312(5) (1995).

301. Gao & Kruger, *supra* note 270, at 33.

302. CONTRACT LAW, act 10.

303. Gao & Kruger, *supra* note 270, at 30.

304. A key to a securitization transaction is to complete a true sale as opposed to secured financing. *See supra* note 91.

Arguably, the issue of the SPV's bankruptcy remoteness is less a relevant concern if the originator is a state-owned Chinese financial institution, for example, an AMC, which is deemed usually unlikely to go bankrupt. However, in 1999, the Chinese central government refused to rescue the insolvent Guangdong International Trust and Investment Corporation ("GITIC"), which was the second largest of its kind in China and owned by the Guangdong provincial government. *See* Lou, *supra* note 33, at n.18. *See also,* Ben Branch & Fei Ji, *Bankruptcy Practice in China, Hong Kong and Taiwan: A Summary,* 2002 ANN. SURV. OF BANK. LAW 341 (2002). The GITIC's bankruptcy raised foreign creditors' concern with the increasing possibility of the bankruptcy of state owned financial entity as the government takes more sweeping financial cleanup. *See, e.g.,* Karby Leggett, *China's Credit Costs Go On Trial With GITIC,* ASIAN WALL ST. J., March 29, 1999, at J3, *available at* 1999WL 5430580.

305. Gao & Kruger, *supra* note 270, at 32–33.

mortgage foreclosure is notoriously difficult. In addition, China's fragmented bankruptcy law does not provide an orderly framework for the reorganization and liquidation of insolvent enterprises.[306] Furthermore, the judicial and administrative discretion involved in the decisions to commence a bankruptcy proceeding against an SOE debtor creates unpredictability in the enforcement of creditors' rights. Thus, the lack of experience in administrative proceedings further compounds the difficulty.

Additional uncertainties arise when foreign investors participate in China's NPL resolution. Recently, the Chinese government issued two new regulations relevant to foreign investment in NPL market.[307] Obviously, the government has recognized the importance of involving outside funds and expertise to resolve NPL issue as well as the closely related conundrum of SOE restructuring. The multi-departmental regulatory regime and opaque approval procedure, however, make it very difficult to accomplish a transaction with foreign participation. In addition, there are also restrictions on the kind of SPVs that foreign investors may set up to take over NPLs.[308] Finally, foreign investors are concerned with China's foreign exchange controls imposed on profit repatriation.[309]

F. Proposal for Special Legislation

China currently does not have a comprehensive legal framework for carrying out securitization. Of course, given the manifested governmental support, the AMCs may well be able to securitize NPLs based on the existing laws and regulations.[310] This approach, however, lacks certainty and predictability, as ad hoc interpretations of ambiguous provisions by various government agencies may result in regulatory conflicts. Moreover,

306. Cohen & Lange, *supra* note 282, at 372.

307. Interim Rules on Financial Assets Management Companies' Absorption of Foreign Funds for Assets Reorganization and Disposal (promulgated on Oct. 26, 2001 by MOFTEC, MOF, and PBoC); Provisional Rules on Reorganization of the State owned Enterprises by Using Foreign Fund (promulgated on Nov. 8, 2001 by the State Economic and Trade Commission, MOF, SAIC, and SAFE), *available at* http://www.isinolaw.com.

308. *China Needs to Revise Laws, Provide More Transparency For NPL Sales*, AFX-ASIA (Nov. 5, 2001), *available at* LEXIS News.

309. *Id.*

310. Interview with Yang, *supra* note 6.

validating every stage of a transaction would entail "a Byzantine process of obtaining consents and approvals from a panoply of government bodies."[311] Thus, the AMCs may encounter substantial difficulty while experimenting with NPL securitization.

Therefore, enacting special legislation is the preferable approach to resolving uncertainties and to paving the way for securitization. In modeling this new securitization law, China may borrow the asset securitization acts passed in Korea and Taiwan. The new law could provide for securitization as a general financial technique and give special accommodation for NPL transactions.

In establishing a comprehensive regime for securitization, the proposed new law should fill the legislative gaps discussed earlier. For example, with respect to possible SPV structures, China may choose to follow the Korean approach, providing for both SPC and SPT, or the Taiwanese approach, which allows only the use of SPTs. As for the true sale issue, China's proposed law may specifically define the relevant criteria as in the Korean legislation. Alternatively, the proposed law may leave the issue open to the courts when disputes arise. The first option suffers from inflexibility, while the second approach flaws with the unpredictability and may fail due to the current judicial incompetence in China. In addition, clear notice procedures should be set up for perfecting an asset transfer. Notice should be deemed given where certified mail has been sent to the obligor at the address appearing in the registration at the State Administration of Industry and Commerce, or in absence of that, to the last known address. If on at least two occasions the mails have returned undelivered, a public notice published in generally circulated newspapers should be deemed valid. Finally, to encourage international participation, the proposed law should also provide for clear guidance on foreign-related issues, including, for example, setting up of a foreign-involved SPV, provision of foreign security, and repatriation of profits overseas.

311. Balbir Bindra, *Legal Initiatives to Promote Securitisation*, *available at* http://www.vinodkothari.com/secchina.htm (last visited Feb. 14, 2003). For example, Huarong's first international NPL auction took a year to obtain approvals from all relevant authorities.

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VIII. CONCLUSION

Resolving the mammoth NPLs burdening China's fragile banking sector is certainly a long march. Any procrastination in implementing NPL disposals, however, could ultimately lead to much greater fiscal burdens, due to the "ice cream effect."[312] The Chinese government has realized the seriousness of the problem and has demonstrated considerable resolve in attacking it.

Securitization has been successfully utilized in the U.S., Japan, Korea, and many other countries as an option of NPL disposition. The Chinese AMCs mandated with NPL resolution are currently exploring NPL securitization. As this Note has suggested, however, the unique nature of Chinese NPLs, the underdevelopment of its capital markets, and the lack of comprehensive legal framework present substantial obstacles to a large-scale NPL securitization program in China. While the bulk of Chinese NPLs are not suitable for securitization, this Note indicates that of the massive portfolio held by the AMCs certain loans are nonetheless securitizable. The Chinese AMC may therefore embark on their pilot NPL securitization program from this identified portion of NPLs. Successful NPL securitization would not only contribute to the ultimate resolution of China's NPL issue, but would also assist the general development of securitization in the local markets.

To facilitate localization of this financial technique, the Chinese government must address the existing market and legal obstacles. This Note thus stresses that the government should further liberalize capital markets, allowing greater participation of both domestic and foreign institutional investors. In addition, this Note proposes enacting special securitization legislation to establish comprehensive and predictable legal infrastructures.

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312. *See supra* note 21 and accompanying text.

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"REGULATION S" AND THE TERRITORIAL APPROACH TO SECURITIES REGULATION: ARE THEY EFFECTIVE?

A STUDY OF UNITED STATES SECURITIES REGULATION IN LIGHT OF BRITISH AND CHINESE SECURITIES REGULATIONS

I. INTRODUCTION

Regulatory issues and problems are inherent in all securities offerings. However, there are different issues raised in securities offerings that take place within a country as opposed to those that take place wholly extraterritorially,[1] i.e. those that are offered and sold outside a country.[2] Under United States ("U.S.") law, the extraterritorial offering poses serious challenges to defining the scope of section 5 of the Securities Act of 1933 ("Securities Act").[3] Section 5 requires an issuer to register its securities offering unless the offering falls within one of the standard exemptions provided in the Securities Act.[4] If no such exemption is satisfied, section 5 prohibits the use of interstate commerce in the offering of unregistered securities. Section 2(7) of the Securities Act defines interstate commerce to include "trade or commerce in securities or any transportation or communication relating thereto . . . between any foreign country and any State, Territory, or the District of Columbia."[5] Because of this definition, the jurisdictional reach of section 5 is potentially quite broad.[6] A literal reading of this provision would include within the scope of section 5 any offering by a U.S. issuer, regardless of the geographical location of the offering, if in the

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1. JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 328 (3d ed. 2001).
2. *See* Guy P. Lander, *Regulation S — Securities Offerings Outside the United States*, 21 N.C. J. INT'L L. & COM. REG. 339, 346 (1996).
3. 15 U.S.C. §§ 77a to 77aa (2000).
4. 15 U.S.C. § 77e (1994); COX ET AL., *supra* note 1, at 326. These exceptions include, *inter alia*, Sections 3(a)(11) (intrastate offering exemption), 4(2) (private offering exemption), and Regulation D of the Securities Act of 1933.
5. Securities Act of 1933 § 2(7), 15 U.S.C. § 77b(a)(7) (2000).
6. COX ET AL., *supra* note 1, at 328–29.

process of selling the security abroad the U.S. mails had been used or telephone calls into the U.S. had been made.[7] Similarly, a foreign offering by a foreign issuer where securities are shortly thereafter traded among U.S. investors in the U.S. market would also trigger section 5's registration requirements.[8]

Given section 5's potential overbreadth and the increasing importance of international securities offerings,[9] the U.S. Securities and Exchange Commission ("SEC") took a series of interpretative and regulatory steps to lessen concerns regarding section 5's application. The SEC's initial step was Securities Act Release No. 4708 in 1964, which took the imprecise position that an offering sold extraterritorially in a manner reasonably designed to preclude distribution or redistribution within or to nationals of the U.S. did not require registration under section 5.[10] For twenty-five years and pursuant to Release No. 4708, the SEC issued inconsistent and vague no-action letters in its attempt to set standards applicable to extraterritorial offerings.[11]

Following this period of uncertainty, the SEC adopted Regulation S.[12] It is based on a territorial approach to section 5 of the Securities Act[13] and provides a registration exemption for wholly extraterritorial offerings.[14] Because the Securities Act as a whole is intended to protect the U.S. markets and investors purchasing in the U.S. markets, whether U.S. or foreign nationals, Regulation S creates explicit safe harbors for extraterri-

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7. *Id.* at 329.

8. *Id.*

9. *See* Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functionalism: A Comparison with Reference to Securities Regulation*, 4 TRANSNAT'L L. & CONTEMP. PROBS. 69 (1994).

10. Registration of Foreign Offerings by Domestic Issuers, Securities Act Release No. 4708, 29 Fed. Reg. 9828 (July 9, 1964), codified at 17 C.F.R. §231 (1991) [hereinafter Release 4708]. Release 4708 provided that registration as a broker-dealer would not be required for offshore sales to non-U.S. persons, or for sales into the U.S. through a U.S.-registered broker-dealer.

11. *Id.*

12. Regulation S — Rules Governing Offers and Sales made Outside the United States Without Registration Under the Securities Act of 1933, 17 C.F.R. §§ 230.901–904 (1990) [hereinafter Reg. S], *amended by* 17 C.F.R. §§ 230.901–905 (1998).

13. Regulation S, Securities Act Release No. 6863, 46 SEC Docket 52 (Apr. 24, 1990).

14. *Id.*

torial distributions and resales of unregistered securities. Through Regulation S, the SEC's territorial approach to securities regulation recognizes the primacy of the laws in which the market and transaction are located rather than focusing on the nature of the securities or the nationality of purchasers, offerors, or issuers.

U.S. regulations dealing with extraterritorial offerings do not, however, operate in a vacuum. In an overseas offering, the securities regime of at least one other country will apply to the offering. The impact of the foreign securities regime varies with the specific requirements of the regime.[15] Depending on whether the foreign regime provides adequate protection determines whether there is an adverse impact on the U.S. markets as a result of extraterritorial offerings not regulated by the SEC. This Note addresses various regulatory approaches to wholly extraterritorial securities offerings in order to determine if Regulation S is adequate in light of those other regimes and frameworks.

There are three basic models of securities regulatory framework: the American type, the English type, and a combination of the two.[16] The American type is characterized by a comprehensive securities law that provides regulatory rules for both primary and secondary markets, and is applicable to issuers, underwriters, brokers, and investment advisors.[17] The American type also has an independent regulatory body responsible for enforcing securities law so as to protect investors, and includes statutory rules and regulations that govern all aspects of investments, from disclosure to market manipulation.[18] The English type, on the other hand, emphasizes listing requirements and the importance of self-regulation by securities participants.[19] Securities laws are interspersed among other laws, such as company and banking law, rather than being separately codified in a comprehensive securities act.[20] The third type of

15. Stephen J. Choi, *The Unfounded Fear of Regulation S: Empirical Evidence on Offshore Securities Offerings*, 50 DUKE L.J. 663, 743 (2000).

16. FINANCIAL REGULATION IN THE GREATER CHINA AREA 117 (Joseph J. Norton, et al. eds., 2000).

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

securities regulatory framework combines the first two and creates a role for both a regulatory body and self-regulation.[21] It establishes a comprehensive securities law, but aims at expansion of the capital markets rather than protection of investors.[22]

Within the American type of regulatory framework, the U.S. takes a territorial approach to securities regulation. This territorial approach is not unique to the U.S. Even though the United Kingdom ("U.K.") regulatory framework is different, it utilizes a territorial approach to securities regulation and similar to the U.S. does not impose the same requirements for wholly extraterritorial offerings as it does for domestic offerings. Because of their different regulatory frameworks, however, the U.S. and U.K. focus on different aspects of the offering in determining whether it is wholly extraterritorial. The U.S. securities regulation focuses on the geographical location of the transaction itself, namely the geographical location of the offering and the place where the securities come to rest. In contrast to the U.S. focus on the transaction, the U.K. approach considers as determinative the "nationality" of the issuer, which is defined in part by location.[23]

Beyond the differing territorial approaches in the U.S. and U.K., there are other diverse approaches to securities regulation around the world. These different approaches do not deal directly with extraterritorial offerings per se as they do not consider geographical factors. Chinese regulators utilize this approach and working within the combination securities framework, focus on the kind of security offered and the nationality of the purchaser, offeror, and issuer. Chinese regulators find the location of the transaction to be completely irrelevant to securities regulation.

This Note analyzes the U.S. approach to regulation of extraterritorial securities transactions in light of other regulatory frameworks and approaches to securities regulation. It goes on to offer improvements to the U.S. system by drawing from other regulatory frameworks and approaches. Part II begins by briefly addressing the problems the SEC faced, prior to Regulation S, considering the U.S. territorial approach to securities regulation and American regulatory framework. It further de-

21. *Id.*
22. *Id.*
23. *See* notes 124–147 and accompanying text for a full discussion.

scribes the purposes and provisions of Regulation S, which embodies the U.S. territorial approach to securities regulation, and also considers the problems created by this approach. Part III examines the Regulation S amendments adopted in 1998 in an attempt to remedy these problems while still utilizing the territorial approach to securities regulation. Part IV examines the U.K. territorial approach to securities regulation as modified by the English regulatory framework. It also compares the U.S. and U.K. systems, weighing their advantages and disadvantages. Part V discusses the Chinese regulation of foreign transactions based on notions completely separate from the territorial approaches utilized by the U.S. and U.K., as influenced by its combination framework, and compares the differing approaches to securities regulation. In Part VI, this Note concludes with a discussion of whether U.S. investors and securities markets would benefit by modifying or replacing the U.S. regulatory framework and territorial approach as embodied in Regulation S.

II. REGULATION S OF THE SECURITIES ACT OF 1933: HISTORY, PURPOSE, AND SPECIFICS

Section 5 of the Securities Act requires the registration of any offer or sale of securities involving the use of interstate commerce, unless there is an exemption.[24] "Interstate commerce" is defined to include trade or commerce in securities between the U.S. and any foreign country.[25] In 1964, the SEC attempted to specify the reach of the Securities Act registration requirements through Securities Act Release No. 4708 ("Release 4708").[26] In Release 4708, the SEC stated that the registration requirements of section 5 of the Securities Act[27] were for the protection of investors in the U.S. markets and, therefore, the SEC would not take action when an issuer who sold to foreign investors

24. 15 U.S.C. §§ 77a to 77m (2000) (regulating distribution of securities). The Securities Act of 1933 was enacted in response to securities market fraud and a lack of public information in the stock markets. It seeks to ensure market competition by mandating full and fair disclosure of all material information to the public. H.R. REP. NO. 73–85, at 1 (1933) (discussing purposes of the Securities Act of 1933).

25. Securities Act of 1933 § 2(7), 15 U.S.C. § 77b(a)(7) (2000).

26. Release 4708, *supra* note 10.

27. Securities Act of 1933 § 5, 15 U.S.C. § 77e (2000).

abroad did not register its securities in accordance with the section 5 requirements.[28]

With the development of international trading markets and the significant increase in wholly extraterritorial offerings, Release 4708 did not answer an increasing number of questions regarding securities laws.[29] As a result, issuers and buyers were unsure when their transactions would be considered "offshore," i.e. wholly extraterritorial, by the SEC, and thus whether they would be exempt from the section 5 requirements.[30] In order to clarify the extraterritorial and international application of the registration provisions of the Securities Act,[31] the SEC adopted Regulation S on April 19, 1990.[32]

Regulation S created safe harbors for extraterritorial transactions that met its requirements. If a transaction met all the requirements of Regulation S, the issuer could be certain that it was exempt from the registration provisions of section 5 and thus not subject to civil or criminal liability for violations of section 5.[33] In addition to providing certainty regarding exemption, Regulation S was promulgated to facilitate foreign securities offerings by U.S. issuers and to allow U.S. investors to provide financings in foreign capital markets.[34] The regulation was also intended to increase U.S. competitiveness offshore and lower the cost of raising capital abroad.[35]

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28. Release 4708, *supra* note 10.

29. *See* Edward F. Greene & Jennifer M. Schneck, *Recent Problems Arising under Regulation S*, INSIGHTS, Aug. 1994, at 2.

30. Proctor & Gamble Co., SEC No-Action Letter, 43 SEC Docket 364 (Feb. 21, 1985); Pan American World Airways, Inc., SEC No-Action Letter, 1975 WL 11264 (June 30, 1975). Violations of section 5, even without scienter, give rise to various forms of civil liability, including rescission of the sales transaction. *See* sections 11, 12, and 17 of the Securities Act of 1933.

31. 15 U.S.C. §§ 77a to 77m (2000).

32. Reg. S, *supra* note 12; *see also* Joel P. Trachtman, *Recent Initiatives in International Financial Regulation and Goals of Competitiveness, Effectiveness, Consistency and Cooperation*, 12 J. INTL. L. BUS. 241, at n.158 (Fall 1991).

33. Securities Act of 1933 § 5, 15 U.S.C. § 77e (2000). Each transaction in which the issuer or buyer seeks to enter must meet the requirements of Regulation S as it provides a "transaction" exemption, not an "entity" exemption.

34. Trachtman, *supra* note 32, at 292.

35. R. Brandon Asbill, *Securities Regulation – Great Expectations and the Reality of Rule 144A and Regulation S; The SEC's Approach to the Internationalization of the Financial Marketplace*, 21 GA. J. INT'L & COMP. L. 145, 161–62 (1991).

Regulation S takes a territorial approach to securities regulation. Its General Statement in Rule 901 states that offers and sales that occur outside the U.S. need not be registered under section 5.[36] It effectively narrows section 5's prohibitions regarding interstate commerce by creating exemptions for transactions involving foreign countries,[37] thus restricting the protective reach of section 5 to investors that purchase securities within the U.S. markets.[38]

The Regulation S approach is consistent with the general approach of the Securities Act. The SEC does not protect U.S. investors that acquire securities outside the U.S. since those investors have chosen to forego the protections of the U.S. securities registration requirements.[39] Likewise, Regulation S states that "[a]s investors choose their markets, they choose the laws and regulations applicable in such markets."[40] Therefore, if the transaction takes place "in" the U.S., the securities must be registered under section 5; if the transaction takes place outside the U.S., the securities need not be registered under section 5.[41]

Whether a transaction falls within Regulation S is determined by the location of the transaction rather than by the identity of the purchaser, although the purchaser's identity may affect the complex determination of where the transaction takes place.[42] Regulation S creates two safe harbors in Rules 903 and 904, both of which provide a manner in which investors can determine with certainty if their transactions are extraterritorial,

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36. Reg. S, *supra* note 12, § 230.901.

37. Reg. S, *supra* note 12.

38. Jon B. Jordan, *Regulation S and Offshore Capital: Will the Amendments Rid the Safe Harbor of Pirates?*, 19 J. INTL. L. BUS. 58, 61 (1998).

39. Trachtman, *supra* note 32, at 295.

40. Reg. S, *supra* note 12; *see also* Trachtman, *supra* note 32, at n.158. As a protection to the consumer, however, Preliminary Note 2 of Regulation S provides that the regulation's exemptions are not available for "any transaction . . . that, although in technical compliance with the rules, is part of a plan or scheme to evade" the registration provisions of the Securities Act. This provision allows for enforcement by the SEC for any unintended uses of Regulation S. Jordan, *supra* note 38, at 64.

41. Reg. S, *supra* note 12. The SEC does not apply registration requirements to protect U.S. citizens purchasing securities abroad; such protection is not necessary to carry out the SEC's principal purpose of ensuring a fair marketplace and consumer protection in the U.S.

42. Trachtman, *supra* note 32, at 295.

i.e. "outside" the U.S.[43] This extraterritorial location is also referred to as "offshore."[44]

A. Rule 903: Issuer Safe Harbor

Rule 903 is the safe harbor applicable to sales by offshore issuers of securities and is often referred to as the "issuer safe harbor."[45] It applies to offers and sales by issuers, distributors, their affiliates, and any persons acting on their behalf.[46] It allows offshore offerings with much fewer restrictions, waiving the registration requirements of section 5. To fall within the issuer safe harbor, two general conditions must be met: (1) The offer and sale must be made in an "offshore transaction" and (2) No "directed selling efforts" may be made in the U.S. by the issuer, underwriter, or other distributor.[47]

The first general condition is met and the sale qualifies as "offshore" if it is not made to a person in the U.S. and, either (1) the buyer is outside the U.S. at the time the buy order originated or (2) the transaction is executed in, on, or through the physical trading floor of a foreign securities exchange.[48] The second general condition required of all offers and sales is that there be no "directed selling efforts."[49] Directed selling efforts are those activities that could reasonably be expected to condition the market in the U.S. for any of the securities offered or sold in reliance on Regulation S.[50]

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43. Reg. S, *supra* note 12.
44. *Id.* § 230.902(h).
45. *Id.* § 230.903.
46. *Id.*
47. *Id.*
48. Reg. S, *supra* note 12, § 230.902(i). "Offshore transaction" is defined as "[a]n offer or sale of securities" that is "not made to a person in the United States; and, [ ] either: (A) [a]t the time the buy order is originated the buyer is outside the United States, or the seller and any person acting on its behalf reasonably believe that the buyer is outside the United States; or (B) … the transaction is executed in, on or through a physical trading floor of a foreign securities exchange that is located outside the United States." *Id.*
49. *Id.* §§ 230.903(b), 230.904(b).
50. *Id.* § 230.902(b)(1). For example, mailing printed materials to U.S. investors, conducting promotional seminars in the U.S., placing ads with radio or TV stations broadcasting into the U.S., or placing ads in publications with a general circulation in the U.S., any of which discuss the offering or condition the market for securities.

In addition to the two general conditions, Rule 903 imposes procedural safeguards to ensure that the securities "come to rest" outside the U.S.[51] Such safeguards vary with the perceived risk that securities offered abroad will flow back into the U.S.[52] Rule 903 is divided into three categories with varying procedural safeguards[53] based on the type of issuer and security.[54] There are no additional procedural safeguards for Category One transactions. Category One includes the securities of non-U.S. issuers, such as the securities of foreign issuers with no "substantial United States market interest" for their securities;[55] securities offered and sold in "overseas directed offerings;"[56] securities backed by the full faith and credit of a "foreign government;"[57] and securities offered and sold pursuant to

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51. *Id.* § 230.903.

52. *Id.*

53. *Id.* § 230.903(c)(1)–(3).

54. *Id.* § 230.902(n).

55. Reg. S, *supra* note 12, § 230.903(c)(1)(i)(A)–(D). A "substantial U.S. market interest" in foreign issuer's securities is defined to exist where at the offering (1) the "securities exchanges and inter-dealer quotation systems in the United States in the aggregate constitute the single largest market for such securities in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation;" or (2) 20 percent or more of the trading in the class of securities took place in, on or through the facilities of securities exchanges and inter-dealer quotation systems in the United States and less than 55 percent of such trading took place in, on or through the facilities of securities markets of a single foreign country in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation." *Id.* § 230.902(n)(i)–(ii).

56. *Id.* § 230.903(c)(1)(ii). An "overseas directed offering" is (1) "an offering of securities of a foreign issuer that is directed into a single country other than the united States to the residents thereof and that is made in accordance with the local laws and customary practices and documentation of such country;" or (2) "an offering of non-convertible debt securities," asset-backed securities or non-participating preferred stock of domestic issuers directed to residents of a single foreign country "in accordance with the local laws, and customary practices and documentation of such country provided that the principal and interest of the securities . . . are denominated in currency other than U.S. dollars and such securities are neither convertible into U.S. dollar-denominated securities no linked to U.S. dollars . . . in a manner that in effect converts the securities to U.S. dollar-denominated securities." *Id.* § 230.902(j).

57. *Id.* § 230.903(c)(1)(iii). A "foreign government" is "the government of any foreign country or of any political subdivision of a foreign country, provided that such government or subdivision would qualify to register securities under the [Securities] Act on Schedule B." *Id.* § 230.902(e).

certain employee benefit plans established under the laws of a foreign country.[58]

There are additional procedural restrictions called transactional restrictions for Category Two transactions.[59] Under these restrictions, securities sold prior to the expiration of a mandatory 40-day restricted period cannot be offered to, sold to, or sold for the benefit of a U.S. person.[60] Regulation S defines "U.S. person" as "any natural person resident in the United States."[61] Therefore, any domestic or foreign national resident in the U.S. is automatically considered a U.S. person for the purposes of Regulation S. Category Two safeguards apply to the equity securities of domestic reporting issuers, securities of foreign reporting issuers with a substantial market interest in

58. *Id.* § 230.902(c)(1). *See also* Jordan, *supra* note 38, at n.57.

59. *Id.* § 230.903(c)(2)(ii)–(iv). There are also offering restrictions. The first offering restriction requires that every distributor agree in writing to comply with the transactional restrictions and provisions of Regulation S. *Id.* § 230.902(h)(1). The second offering restriction requires that documents used in connection with transactions under Rule 903, i.e. sales and offers, must contain the following language: "to the effect that the securities have not been registered" and "may not be offered or sold in the United States or to United States persons." *Id.* § 230.902(h)(2).

60. *Id.* § 230.903(c)(2)(iii). If these securities are sold within the restricted period, the purchaser must also be informed of the transactional restrictions. *Id.* § 230.903(c)(2)(iv). This section was drastically changed by the 1998 amendments, which extended the restricted period to one year. *See* notes 91–106, *infra*, and accompanying text.

61. *Id.* § 230.902(o)(1)(i). In determining a corporation's residency, the place of incorporation generally controls. *Id.* § 230.902(o)(1)(ii). If, however, a corporation incorporated in a foreign jurisdiction was created for the purpose of investing in securities not registered with the SEC, it will be deemed a U.S. person for the purposes of Regulation S. *Id.* § 230.902(o)(1)(viii)(A)–(B).

the U.S.[62] for their securities, and securities of non-reporting foreign issuers.[63]

The Category Two procedural restrictions also apply to Category Three transactions.[64] In addition, purchasers of Category Three securities must certify that they are not U.S. persons and are not acquiring the securities for the account or benefit of a U.S. person.[65] The purchaser must also continue to resell securities under Regulation S rules.[66] Category Three safeguards apply to the securities of all other issuers not covered under the first two categories.[67]

B. Rule 904: Resale Safe Harbor

Rule 904, the "resale safe harbor,"[68] provides for the offshore resale of unregistered securities by persons other than the issuer, distributor, or any of their respective affiliates or agents.[69] Like Rule 903, it requires two general conditions: (1) the offer

62. *Id.* § 230.903(c)(2). A "substantial U.S. market interest" in foreign issuer's securities is defined to exist where at the offering (1) the "securities exchanges and inter-dealer quotation systems in the United States in the aggregate constitute the single largest market for such securities in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation;" or (2) 20 percent or more of the trading in the class of securities took place in, on o through the facilities of securities exchanges and inter-dealer quotation systems in the United States and less than 55 percent of such trading took place in, on or through the facilities of securities markets of a single foreign country in the shorter of the issuer's prior fiscal year or the period since the issuer's incorporation." *Id.* § 230.902(n)(i)–(ii).

63. *Id.* § 230.903(c)(2). Specifically, Category Two restrictions apply to debt securities, non-participating preferred stock, and asset-backed securities of non-reporting foreign issuers. *Id.* This section was drastically changed to exclude equity securities of domestic reporting issuers in the 1998 amendments. *See* notes 91–106, *infra*, and accompanying text.

64. *Id.* § 230.903(c)(3)(i).

65. *Id.* § 230.903(c)(3)(iii)(B)(4). There are also offering restrictions. The first offering restriction requires that every distributor agree in writing to comply with the transactional restrictions and provisions of Regulation S. *Id.* § 230.902(h)(1). The second offering restriction requires that documents used in connection with transactions under Rule 903, i.e. sales and offers, must contain the following language: "to the effect that the securities have not been registered" and "may not be offered or sold in the United States or to United States persons." *Id.* § 230.902(h)(2).

66. *Id.* § 230.903(c)(3)(iii)(B).

67. *Id.* § 230.903(c)(3).

68. *Id.* § 230.904.

69. *Id.*

and sale must be made in an "offshore transaction" and (2) no "directed selling efforts" may be made in the U.S. by the issuer, underwriter, or other distributor.[70] To qualify as "offshore," a resale must not be made to a person in the U.S. and, either (1) the buyer must be outside the U.S. at the time the buy order is originated or (2) the transaction must be executed in, on, or through the facilities of one of the designated offshore securities markets[71] enumerated in the regulation.[72] While the "directed selling efforts" requirements of Rule 904 are the same as in Rule 903,[73] Rule 904 requires no additional procedural safeguards to ensure that the securities "come to rest" abroad.[74]

C. Abuses of the Original Regulation S

Not long after Regulation S was adopted, market participants quickly identified and took advantage of significant loopholes in the regulation.[75] Within one year of the adoption of Regulation S, the SEC filed its first enforcement action involving securities violations associated with the regulation.[76] In some instances,

70. *Id.*

71. *Id.* § 230.902(i). "Offshore transaction" is defined as "[a]n offer or sale of securities" that is "not made to a person in the United States; and, [ ] either: (A) [a]t the time the buy order is originated the buyer is outside the United States, or the seller and any person acting on its behalf reasonably believe that the buyer is outside the United States; or (B) … the transaction is executed in, on or through the facilities of a designated offshore securities market." *Id.*

72. Section 230.902(a) defines "designated offshore securities market" as:

(1) the Eurobond market, the Amsterdam Stock Exchange, the Australian Stock Exchange Limited, the Bourse de Bruxelles, the Frankfurt Stock Exchange, The Stock Exchange of Hong Kong Limited, The International Stock Exchange of the United Kingdom and the Republic of Ireland, Ltd., the Johannesburg Stock Exchange, the Bourse de Luxembourg, the Borsa Valori di Milan, the Montreal Stock Exchange, the Bourse de Paris, the Stockholm Stock Exchange, the Tokyo Stock Exchange, the Toronto Stock Exchange, the Vancouver Stock Exchange, and the Zurich Stock Exchange.

(2) any foreign securities exchange or non-exchange market designated by the Commission.

This section was changed by the 1998 Amendments to include later designated markets. *See* note 90, *infra*, and accompanying text.

73. *See* notes 51–52, *supra*, and accompanying text.

74. Reg. S, *supra* note 12, §§ 230.902(a), 230.904(a)–(b).

75. *See* Jordan, *supra* note 38, at 59.

76. Securities and Exchange Comm'n v. Westdon Holding Inv., Inc., Litigation Release No. 13,085, 50 SEC Docket 229 (S.D.N.Y. Nov. 7, 1991).

issuers created offshore shell entities to sell unregistered securities back into the U.S.[77] Other abuses included illegal resales within the restricted period after purchase,[78] use of promissory notes in purchasing Regulation S securities when the expectation of repayment stemmed from the resale of securities back into the U.S.,[79] and use of the resale safe harbor to "wash off" restrictions from otherwise restricted securities.[80] These and other abuses[81] tainted the reputation of Regulation S as an efficient means for raising capital overseas and frustrated its goal of protecting U.S. investors. These problems prompted the amendments of the regulation.

III. AMENDMENTS TO REGULATION S

Regulation S was amended in 1998[82] "to stop the abusive practices in connection with offerings of equity securities purportedly made in reliance on Regulation S."[83] Because most

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77. Securities and Exchange Comm'n v. Softpoint, Inc., Litigation Release No. 14,480, 59 SEC Docket 426 (S.D.N.Y. Apr. 27, 1995); United States v. Sung, Litigation Release No. 14,901, 61 SEC Docket 2275 (M.D. Fla. May 6, 1996).

78. Securities and Exchange Comm'n v. Scorpion Techs., Inc., Litigation Release No. 14,814, 61 SEC Docket 749 (Feb. 9, 1996).

79. *In re* Candie's, Inc., Securities Act Release No. 7,263, 61 SEC Docket 758 (Feb. 21, 1996).

80. In Touch Global, LLC, [1996–1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,209, at 77,038–39 (Nov. 14, 1995).

81. *See* Securities and Exchange Comm'n v. Schiffer, et al., Litigation Release No. 15,435, 65 SEC Docket 337 (Aug. 7, 1997); *In re* GFL Ultra Fund Ltd., Securities Act Release No. 7,423, 64 SEC Docket 1958 (June 18, 1997); Securities and Exchange Comm'n v. PanWorld Mineral Int'l, Inc., Litigation Release No. 15,380, 64 SEC Docket 1874 (June 2, 1997); Securities and Exchange Comm'n v. Members Service Corp., Litigation Release No. 15,371, 64 SEC Docket 1622 (May 22, 1997); Securities and Exchange Comm'n v. Rosenfeld, Litigation Release No. 15,274, 64 SEC Docket 80 (Mar. 5, 1997); Securities and Exchange Comm'n v. Scorpion Techs., Inc., Litigation Release No. 14,814, 61 SEC Docket 749 (Feb. 9, 1996); Securities and Exchange Comm'n v. Sarivola, Litigation Release No. 14,704, 60 SEC Docket 1602 (Oct. 31, 1995); Securities and Exchange Comm'n v. EnvirOmint Holdings, Inc., Litigation Release No. 14,683, 60 SEC Docket 1202 (Oct. 6, 1995); Securities and Exchange Comm'n v. Rehtorik, Litigation Release No. 13,975, 56 SEC Docket 368 (Feb. 23 1994).

82. Regulation S, 17 C.F.R. § 230.901–905 (2002) [hereinafter Amended Reg. S]; Offshore Offers and Sales, Securities Act Release No. 7,505, 63 Fed. Reg. 9,632 (Feb. 25, 1998) [hereinafter Amending Release].

83. Amending Release, *supra* note 82, at 9,632.

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abuses of the regulation involved domestic issuers, the most drastic changes to the regulation were in the sections that apply to domestic issuers.[84] In contrast, the changes that applied to foreign issuers were minimal.[85] The most important change to the regulation was the amendment to Rule 903, which reclassified domestic reporting equity issuers from the second safe harbor category to the third category.[86] Another important change was Rule 905, a new rule that categorized equity securities of both reporting and non-reporting domestic issuers as restricted securities within the meaning of Rule 144 of the Securities Act ("Rule 144").[87]

A. Amendments to the General Conditions

The two general conditions that must be met for a securities transaction to fall within the Rule 903 or Rule 904 exemption were very slightly modified.[88] The first requirement, that any offer or sale must be made in an "offshore transaction," did not change.[89] The second requirement, prohibiting "directed selling efforts" in the U.S., only changed with respect to "designated offshore securities markets" so that Rule 904 now includes securities markets that were designated as such after the original regulation was adopted.[90]

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84. *Id.* at 9,632–33.

85. Amended Reg. S, *supra* note 82, § 230.904; Amending Release, *supra* note 82, at 9,633. The SEC did warn that it would still "monitor practices in this area" and "revisit the issue" should abuses occur. *Id.*

86. Amended Reg. S, *supra* note 82, § 230.903(b)(3); Amending Release, *supra* note 82, at 9,634–35. *See* Jordan, *supra* note 38, at n.210.

87. Amended Reg. S, *supra* note 82, § 230.905; Amending Release, *supra* note 82, at 9,636. See Rule 144, 17 C.F.R. §230.144 (2002). All securities under Rule 144 restricted securities status are subject to, *inter alia*, a one-year holding period.

88. Amended Reg. S, *supra* note 82, §§ 230.903(a)(1)–(2), 230.904(a)(1)–(2).

89. *Id.* §§ 230.903(a)(1), 230.904(a)(1). *See also id.* § 230.902(h), where the definition of an "offshore transaction" has not changed.

90. *Id.* § 230.902(b). The additional exchanges that have been added to the definition of a designated offshore securities market include the Alberta Stock Exchange, the Bermuda Stock Exchange, the Copenhagen Stock Exchange, the European Association of Securities Dealers Automated Quotation (the European Equivalent to NASDAQ), the Helsinki Stock Exchange, the Irish Stock Exchange, the Istanbul Stock Exchange, the Mexican Stock Exchange, the Oslo Stock Exchange, the Stock Exchange of Singapore Ltd., and the Warsaw Stock Exchange.

B. Amendments to Rule 903, the Issuer Safe Harbor

There were amendments to Rule 903's procedural safeguards imposed on the three different categories of securities in order to ensure that the securities "come to rest" outside the U.S. Category One of the issuer safe harbor was generally unaffected by the amendments.[91] Category Two's coverage of securities of foreign reporting issuers with a substantial market interest for their securities in the U.S. and non-reporting foreign issuers also remained changed.[92]

Category Two of the issuer safe harbor was changed, however, so that it no longer includes equity securities of domestic reporting issuers; Category Three now covers such securities.[93] This class of securities was hardest hit by the amendments since domestic reporting issuers no longer enjoy the benefits of a shorter 40-day holding period,[94] but now must hold the equity securities for one year.[95] While the amendments have greatly affected the type of securities covered by Category Two, the requirements under this category have remained the same, for the most part, with only a few minor changes to the terminology used in the transactional restrictions.[96]

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91. *Id.* § 230.903(b)(1). One class of securities covered by Category One has been affected. Securities of domestic issuers falling under this category that are sold to foreign resident employees pursuant to employee benefit plans governed by foreign law are now classified as restricted securities within the meaning of Rule 144 of the Securities Act. *Id.* Therefore, these securities are now subject to a one-year holding period before they can be resold in the U.S. Amending Release, *supra* note 82, at 9,634. *See also* Amended Reg. S, *supra* note 82, § 230.905. Prior to the amendments, these securities were not subject to any kind of holding restrictions or limitations other than those previously specified under Category One. *See* Reg. S, *supra* note 12, § 230.903(c)(1)(iv).

92. Amended Reg. S, *supra* note 82, § 230.903(b)(2).

93. *Id.* § 230.903(b)(2)–(3). *See also* Reg. S, *supra* note 12, § 230.903(c)(2).

94. Amended Reg. S, *supra* note 82, § 230.903(b)(2)(ii).

95. *Id.* § 230.903(b)(3)(iii)(A).

96. The terminology used to describe the holding period applicable to the Regulation S safe harbors (here the 40-day period) in the original Regulation S was "restricted period." Reg. S, *supra* note 12, § 230.903(c)(2)(iii)–(iv). The amended Regulation S uses instead the term "distribution compliance period." Amended Reg. S, *supra* note 82, § 230.903(b)(2)(i)–(ii). The SEC changed the term "restricted period" to "distribution compliance period" to avoid confusion between the requirements under the issuer safe harbor from those applicable under Rule 144, now included in the new Rule 905, which contains the term "restricted securities." *See id.* § 230.905; *see also* Amending Release, *supra* note 82, at 9,635.

Category Three continues to be the residual safe harbor category, covering all securities not covered by Categories One or Two.[97] Category Three now includes equity securities of domestic issuers, and foreign non-reporting issuers with a substantial market interest in the U.S. for their securities.[98] The procedures for Category Three continue to be the most rigorous because the likelihood that the securities will flow back into the U.S. is greatest with these issuers.[99]

The stringent transactional restrictions under Category Three were modified and are now divided between debt and equity securities.[100] The transactional restrictions for debt securities are less stringent than those for equity securities and have not changed. Debt securities continue to be subject to a 40-day distribution compliance period.[101] The transactional restrictions for equity securities, however, are now much more comprehensive.[102] Category Three equity securities are subject to a one-year distribution compliance period.[103] As in the original Regulation S, if an offer or sale is made within this distribution compliance period, the purchaser must certify that he is not a U.S. person nor acquiring the securities for the benefit of a U.S. per-

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The offering restrictions under Category Two have not changed. Distributors must still agree in writing that all offers and sales made prior to the expiration of the distribution compliance period be conducted in compliance with the rules governing Regulation S. Amended Reg. S, *supra* note 82, §§ 230.903(b)(2)(i), 230.902(g)(1). Also, all offering materials and documents used in connection with offers and sales prior to the expiration of the distribution compliance period must include statements that the securities have not been registered and may not be sold in the U.S. or to U.S. persons, absent registration or an exemption. *Id.* §§ 230.903(b)(2)(i), 230.902(g)(2).

97. *Id.* § 230.903(b)(3).

98. *Id.* § 230.903(b)(3). These three groups of equity securities were previously in Category Two. *See* notes 59–63, *supra*, and accompanying text.

99. Amending Release, *supra* note 82, at 9,635.

100. Amended Reg. S, *supra* note 82, §§ 230.903(b)(3)(i) and (ii), respectively.

101. *Id.* § 230.903(b)(3)(ii)(A). Debt securities must also be represented "upon issuance by a temporary global security which is not exchangeable for definitive securities until the expiration of the 40-day distribution compliance period." *Id.* § 230.903(b)(3)(ii)(B).

102. *Id.* § 230.903(b)(3)(iii)–(iv).

103. *Id.* § 230.903 (b)(3)(iii)(A). Distributors selling Category Three equity or debt securities prior to the expiration of the applicable distribution compliance period must provide notice to the purchaser that he is also subject to the same restrictions as the selling distributor. *Id.* § 230.903(b)(3)(iv).

son.[104] The purchaser must also continue to resell securities under Regulation S rules.[105] In addition, under the amendments, the purchaser must agree not to engage in hedging transactions with regard to these securities unless in compliance with the Securities Act.[106]

C. Amendments to Rule 904 and the New Rule 905: Resale Limitations

While the resale safe harbor of Rule 904 has substantively stayed the same, the rules governing the effect of resales of domestic securities have been modified by new Rule 905. The SEC added Rule 905 to Regulation S "to clarify the legal obligations of purchasers of securities under Regulation S."[107] The rule provides that equity securities of domestic issuers acquired from the issuer, a distributor, or any of their affiliates in a transaction subject to Regulation S are "restricted securities" as defined in Rule 144.[108] Because these securities are "restricted," the resale safe harbor created by Rule 904 can no longer be used to avoid applicable restrictions.[109] Instead, these securities are subject to the restrictions of Rule 144, including a one-year holding period before they can be resold.[110]

Rule 905 also provides that restricted securities as defined under Rule 144 "will continue to be deemed … restricted securities, notwithstanding that they were acquired in a resale transaction" under the resale safe harbor of Rule 904.[111] As a result, the resale of restricted securities offshore under the Rule 904 safe harbor does not "wash off" the restricted status of those

104. *Id.* § 230.903(b)(3)(iii)(B)(1).

105. *Id.* § 230.903(b)(3)(iii)(B)(2).

106. *Id.* Category Three transactional restrictions continue to require that a legend be placed on the securities of domestic issuers stating that transfers in these securities are prohibited except in accordance with the provisions governing Regulation S. *Id.* § 230.903(b)(3)(iii)(B)(3). Under the amendments, this legend must now also contain a provision stating that hedging in these securities may not be conducted unless in compliance with the Securities Act. *Id.* The transactional restrictions continue to require the issuer to refuse to register any transfer of securities not made in compliance with Regulation S. *Id.* § 230.903(b)(3)(iii)(B)(4).

107. Amending Release, *supra* note 82, at 9,636.

108. Amended Reg. S, *supra* note 82, § 230.905.

109. *Id.* § 230.905.

110. 17 C.F.R. § 230.144(d)(1).

111. Amended Reg. S, *supra* note 82, § 230.905.

securities to allow them to be freely sold into the U.S. by the purchaser.[112]

New Rule 905 has also had a dramatic effect on the use of promissory notes in the purchase of Regulation S securities. By deeming domestic equity securities to be restricted securities under Rule 144, the SEC effectively prohibited the use of promissory notes where the expected method of repayment was the resale of the securities via the Rule 904 resale safe harbor.[113] Rule 905, in conjunction with Rule 144, tolls the one-year holding period unless the promissory note provides for full recourse against the purchaser of the securities and is secured by collateral, other than the securities purchased, having a fair market value at least equal to the purchase price of the securities.[114] In addition, after the expiration of the one-year holding period, the promissory note must be paid in full before the Rule 144 restricted securities may be resold.[115] This "ensures that the funds obtained through the Rule 144 resale" into the U.S. markets "will not be used to pay off the promissory note."[116]

D. Post-Amendment Abuses of Regulation S

The amendments appear to have deterred the abuses prevalent under the original Regulation S.[117] These amendments have explicitly prohibited illegal resales within the distribution compliance period by deeming the securities restricted under Rule 144. Requiring compliance with Rule 144 automatically imposes the longer one-year waiting period during which time a considerable amount of information about an issuer may emerge. Therefore, foreign investors are unlikely to maintain any informational advantage over domestic investors.[118] The amendments have also abolished the abuse involving promissory notes in purchasing Regulation S securities by explicitly prohibiting the use of promissory notes for such purpose and by imposing Rule 144 restrictions. Moreover, the use of the resale

112. Amending Release, *supra* note 82, at 9,637.
113. *Id.*
114. *Id.*
115. *Id.*
116. *Id.*
117. *See* Amending Release, *supra* note 82.
118. Stephen J. Choi, *The Unfounded Fear of Regulation S: Empirical Evidence on Offshore Securities Offerings*, 50 DUKE L.J. 663, 729 (2000).

safe harbor to "wash off" restrictions from otherwise restricted securities has been remedied by the application of Rule 144 to the securities.

Nonetheless, through the Regulation S amendments, the SEC has taken two steps forward and one step back. While it has prevented abuses and extended protection to U.S. investors, it has frustrated the raising of capital abroad. Because the amendments have lengthened the distribution compliance period, they have hindered the ability to raise capital through foreign investments, one of the main purposes of Regulation S.[119] Essentially, the amendments deter domestic reporting issuers from raising capital under Regulation S because it is more costly due to the expanded resale restrictions created by the amendments.[120] This is because restricted shares normally must be sold at a discount relative to the price of shares that are freely tradable in the public markets.[121] The size of that price discount reflects, at least in part, the compensation buyers receive for giving up the ability to readily resell the shares immediately in the public market.[122] Thus, the size of the price discount has enlarged with the increase in time the shares must be held before they can be sold in the U.S. markets.[123]

Under the American-type regulatory framework, the SEC as the central regulatory body, has clearly been effective in regulating securities and protecting investors. As the amendments to Regulation S prove, the comprehensive securities laws of the U.S. provide a flexible means through which the SEC can adequately regulate and enforce. While the U.S. method is successful, it is unclear whether it is as effective as it could be. In order to determine if the U.S. system can be improved, it is important to consider the securities regulatory systems of other countries.

IV. THE UNITED KINGDOM'S REGULATION OF EXTRATERRITORIAL SECURITIES TRANSACTIONS

U.K. regulators work within the English-type regulatory framework, which emphasizes listing requirements and self-

119. *Id.*
120. Amending Release, *supra* note 82, at 9,639.
121. *Id.*
122. *Id.*
123. *Id.*

regulation of securities participants.[124] The U.K. Financial Services Authority (formerly the Securities and Investments Board) is the single direct statutory "super-regulator" responsible for making rules, regulations, and codes that govern the entire financial services industry.[125] While the Financial Services Authority ("FSA") relies heavily on self-regulation,[126] it maintains power to review the particular rules of self-regulating organizations to ensure they are operating within the statutory framework and may impose individual mandatory rules on any self-regulating organization.[127]

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124. FINANCIAL REGULATION IN THE GREATER CHINA AREA 117 (Joseph J. Norton, et al. eds., 2000). The listing requirements are beyond the scope of this note. For a full discussion of U.K. listing requirements, *see* ALISTAIR ALCOCK, THE FINANCIAL SERVICES AND MARKETS ACT 2000: A GUIDE TO THE NEW LAW 199–207 (2000).

125. Financial Services and Markets Act 2000, ch. 8, § 2 (2000). The Financial Services Authority replaced eighteen other U.K. regulators: Supervision and Surveillance Division of the Bank of England; Insurance Directorate of the U.K. Department of Trade and Industry; Lloyd's; the Building Societies Commission; the Friendly Societies Commission; Registry of Friendly Societies; Personal Investment Authority, a self-regulatory organization; Securities and Futures Authority, a self-regulatory organization; Investment Management Regulatory Organization, a self-regulatory organization; and nine recognized professional bodies: Law Society of England and Wales, Law Society of Scotland, Law Society of Northern Ireland, Institute of Chartered Accountants in England and Wales, Institute of Chartered Accountants in Scotland, Institute of Chartered Accountants in Ireland, Chartered Association of Certified Accountants, Institute of Actuaries, and Insurance Brokers Registration Council. *Id.*

126. Patrick M. Creaven, *Note: Inside Outside Leave Me Alone: Domestic and EC-Motivated Reform in the U.K. Securities Industry*, 60 FORDHAM L. REV. 285, 289–90 (1992). There are four self-regulating organizations in the U.K. A self-regulating organization is a body that regulates the conducting of investment business of any king by enforcing binding rules upon its members or others subject to its control. Financial Services Act 1986, ch. 60, § 8(1) (1986). *See also* JAMES J. FISHMAN, THE TRANSFORMATION OF THREADNEEDLE STREET: THE DEREGULATION AND REREGULATION OF BRITAIN'S FINANCIAL SERVICES 84–97 (1993).

127. FISHMAN, *supra* note 126, at 293. The Secretary of State of the Department of Trade and Industry has power to regulate investments and securities. The Department of Trade and Industry delegated this power to the Financial Services Authority, which is considered a private agency. Financial Services Act 1986, ch. 60, § 114.

The Financial Services Act 1986[128] and the Financial Services and Markets Act 2000[129] (collectively the "Financial Services Acts") govern investments and securities in the U.K.[130] The Financial Services Acts are a comprehensive regime of investor protection[131] intended to curb abuses and build public confidence in the financial services industry by providing more governmental oversight.[132] They affect a much larger area than mere securities offering and trading, covering various types of investors, investments, and investment firms, as well as encompassing the general company law and banking provisions that embrace the entire range of the FSA, including banking, insurance, accounting, lawyering, and investing.[133]

In adopting the Financial Services Acts, the U.K. authorities' concern was mainly limited to the possibility that firms would go offshore as a result of complex and restricting regulations and transact their operations in the U.K. from a foreign office.[134] The Financial Services Acts addressed this issue by requiring all self-regulating firms "within the U.K." to be officially authorized.[135] This authorization subjects the firm to regulation by the

128. Financial Services Act 1986, ch. 60 (epealed and replaced by Financial Services and Markets Act 2000), *reprinted in* NORMAN S. POSER, INTERNATIONAL SECURITIES REGULATION: LONDON'S "BIG BANG" AND THE EUROPEAN SECURITIES MARKETS app. (1990).

129. Financial Services and Markets Act 2000, ch. 8, *reprinted in* ALISTAIR ALCOCK, THE FINANCIAL SERVICES AND MARKETS ACT 2000: A GUIDE TO THE NEW LAW, app. (2000). While some provisions in the Financial Services Act 1986 have been replaced by the equivalent provisions in the Financial Services and Markets Act 2000, none of the amendments affect the analysis here as the same exemptions for extraterritorial issuances still exist. *See id.* for an in-depth discussion of the differences.

130. While the Financial Services and Markets Act 2000 replaced the Financial Services Act 1986, they are both important in the analysis regarding the purposes and methods of securities regulation in the U.K.

131. Financial Services and Markets Act 2000, ch. 8, §5. *See also* J.H. DALHUISEN, THE NEW U.K. SECURITIES LEGISLATION AND THE E.C. 1992 PROGRAM 1 (1989); ALCOCK, *supra* note 129, at 54.

132. Financial Services and Markets Act 2000, ch. 8, §§ 3 and 6. *See also* Creaven, *supra* note 126, at 290.

133. DALHUISEN, *supra* note 131, at 1; ALCOCK, *supra* note 129, at 51–54.

134. DALHUISEN, *supra* note 131, at 111. Of course, the U.K. authority had additional concerns, but they are beyond the scope of this note.

135. *Id.* at 2–3; Financial Services Act 1986, ch. 60, sched. 1, Part II, § 13; Financial Services and Markets Act 2000, ch. 8, schd. 2, Parts I and II. Acting without authorization to engage in investment transactions leads to unen-

FSA. A firm is "within the U.K." if it has its head office, or the office handling the issuance of securities, within the territory of the U.K.[136] Thus, the FSA regulates all authorized firms, even offshore firms with their head offices *outside* the U.K. if any of the branch offices within the U.K. are issuing or selling securities.[137] This leads to regulatory duplication since the foreign country in which the head office is located will also likely regulate the firm and indirectly that firm's U.K. branch office.[138] The FSA has discretion to determine which, if any, U.K. regulations apply to the firm that is subject to dual regulation.[139] The U.K. regulates offshore transactions by dealing directly with the issuer rather than also focusing on the transaction as in Regulation S.[140] Unlike the SEC, the FSA does not consider where the securities "come to rest;" it only considers the location of the initial purchaser rather than the ultimate purchaser and imposes no mandatory holding period on the securities.[141]

The FSA is more flexible than the SEC since it allows a foreign issuer to act through a domestic broker and still escape the authorization regulations, provided that the firm's clients are not in the U.K.[142] While this is an exception not allowed by the SEC, the underlying rationale of both the FSA and SEC is the same: foreign investors who transact with foreign issuers do not benefit from domestic investor protections.[143] In this way and like the SEC, the FSA does not apply its regulatory restrictions to offshore offers to non-U.K. clients.[144]

The U.S. and U.K. extraterritorial securities regulation regimes only differ slightly since both countries utilize a territorial approach. Nonetheless, the U.K. approach is easier to apply because it only emphasizes the location of the issuer, rather

forceable contracts and potential criminal charges. ALCOCK, *supra* note 129, at 52.

136. Financial Services and Markets Act 2000, ch. 8, § 418.

137. ALCOCK, *supra* note 129, at 55–56. The FSA may also develop further rules that regulate extraterritorial investments if that investment business is contrary to the U.K.'s international obligations. Financial Services Act 1986, ch. 60, § 48; DALHUISEN, *supra* note 131, at 111.

138. ALCOCK, *supra* note 129, at 55–56.

139. *Id.*

140. *Id.* at 113.

141. *See* Financial Services and Markets Act 2000, ch. 8.

142. DALHUISEN, *supra* note 131, at 111.

143. Release 4708, *supra* note 10.

144. DALHUISEN, *supra* note 131, at 111.

than also considering the ultimate destination of the securities. The simpler system, however, is not always better. First, the U.K. system does not impose any restrictions on resales with the result that regulations can be easily circumvented and abused, much like the original Regulation S. As the original abuses of Regulation S proved, domestic investors are not protected when unregulated securities are sold back into the domestic market shortly after their exempt initial offering.[145] On the other hand, Regulation S offerings are generally offered at a large discount because they involve restricted securities and such restricted securities can be resold only abroad. Under Regulation S, this discount only benefits foreign investors.[146] The U.K. system does not hinder domestic investors in this way.

Second, at the same time that the U.K. approach does not protect its domestic investors, it also extends the extraterritorial reach of its securities laws too broadly and often infringes another country's securities regulation by regulating issuers outside the U.K. For example, if a U.S. issuer has a branch office in the U.K., it will be subject to U.K. regulations even if that issuer is only offering securities to investors located in the U.S. Because the U.S. issuer is offering to investors in the U.S., it is subject to SEC rules and regulations, e.g. registration. There is thus no need for the additional U.K. regulation of this type of extraterritorial transaction. Yet, the U.K. approach provides regulation.

In addition to the SEC's effective territorial approach, the SEC regulatory scheme is more effective and enforceable because of its centralized regulatory body. This centralization provides easier application and enforceability than the U.K.'s heavy dependence on self-regulating organizations fulfilling their duty to report to the FSA. Moreover, there are the many disadvantages inherent in self-regulation, e.g. conflicts of interest, limited legal powers, lack of adequate public accountability, problems of jurisdiction in an increasingly global market, "old boy" network influences, and the need for a public agency element in the regulatory response to international securities

145. *See* notes 75–81, *supra*, and accompanying text.

146. For a thorough discussion regarding various reasons that neither price discounts nor restricted resales adversely affects U.S. investors, *see* Choi, *supra* note 118, at 678.

fraud.[147] Given these disadvantages, the U.S. territorial approach, implemented through a centralized regulatory body, is the more effective system as the SEC appropriately focuses on the whole transaction, considering the location of the buyer and securities, rather than focusing solely on the issuer's location.

V. CHINESE REGULATION OF FOREIGN SECURITIES TRANSACTIONS

Once the home of the largest stock market in Asia, China's Communist party eliminated securities market activities in 1949 when it implemented its highly planned economy.[148] However, with economic reforms initiated in 1979, the Chinese government changed its approach by sanctioning and actively nurturing a controlled securities market in order to facilitate the mobilization of capital.[149] Because shares were associated with capitalism, however, they remained a sensitive topic subject to both political and economic debate.[150] Despite this debate, some enterprises, driven by a dire need for capital, issued shares to employees and state-owned enterprises, and soon found that share issuance was a convenient and effective way of raising much needed capital.[151] Thus, the securities markets were reborn in China.

China's primary objective in securities regulation is to expand its capital markets and to control its companies, regardless of their geographical location, rather than to protect its investors. Issuance of shares in China operates within a combination framework based on numerous laws, regulations, and rules, including the Company Law of the People's Republic of China of 1994,[152] and the Securities Law of the People's Republic of

147. GEORGE P. GILLIGAN, REGULATING THE FINANCIAL SERVICES SECTOR 94 (1999).

148. FINANCIAL REGULATION IN THE GREATER CHINA AREA, *supra* note 124, at 103.

149. *Id.*

150. *Id.*

151. *Id.*

152. ZHONGHUA RENMIN GONGHEGUO GONGSI FA [COMPANY LAW OF THE PEOPLE'S REPUBLIC OF CHINA], *translated in* LEGISLATIVE AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA, THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1993, at 269–318 (1995) [hereinafter Company Law], *reprinted in* Materials on Corpo-

China of 1999.[153] Share issuance is also controlled by a series of guidelines published by the China Securities and Regulatory Commission ("CSRC"), the regulatory body created by the State Council Securities Commission.[154] The CSRC is responsible for drafting and enforcing securities-related legislation, as well as approving issuances of all shares to the public, both domestic and foreign.[155]

The Company Law of the People's Republic of China ("Company Law") was formally adopted on December 29, 1993.[156] In order to facilitate investment by foreigners and overseas investors in Chinese companies, the Company Law created a structure through which Chinese issuers are able to attract foreign capital.[157] Companies may offer shares to overseas investors by listing on foreign stock exchanges if they satisfy all the regulations applicable to domestic issuances and obtain approval from both the CSRC and the State Commission for Restructuring the Economic System.[158] Special regulations govern foreign issuances and are the only manner through which Chinese companies can issue shares to foreign shareholders.[159] To facilitate China's control over Chinese companies' offerings even in a foreign market, a Chinese company may list shares issued to foreigners only on an exchange in a foreign country that has en-

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rate and Securities Law of the People's Republic of China (Shen Sibao ed., 1999).

153. ZHONGHUA RENMIN GONGHEGUO ZHENGQUAN FA [SECURITIES LAW OF THE PEOPLE'S REPUBLIC OF CHINA], *translated in* LEGISLATIVE AFFAIRS COMM'N OF THE STANDING COMM. OF THE NAT'L PEOPLE'S CONGRESS OF THE PEOPLE'S REPUBLIC OF CHINA, THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 1998, at 135–76 (1999) [hereinafter Securities Law], *reprinted in* MATERIALS ON CORPORATE AND SECURITIES LAW OF THE PEOPLE'S REPUBLIC OF CHINA (Shen Sibao ed., 1999).

154. FINANCIAL REGULATION IN THE GREATER CHINA AREA, *supra* note 124, at 104. There are other applicable securities related laws, regulations, and rules, but they are beyond the scope of this article. *See id.*, ch. 4, "The Securities System in China," for a thorough discussion.

155. I.A. TOKLEY & TINA RAVN, COMPANY AND SECURITIES LAW IN CHINA 69 (1998).

156. *Id.* at 3; Company Law, *supra* note 152.

157. *Id.* at 82; Company Law, *supra* note 152, arts. 85, 155.

158. Company Law, *supra* note 152, art. 3. *See also* TOKLEY, *supra* note 155, at 82–89.

159. TOKLEY, *supra* note 155, at 83. For purposes of these Special Regulations, a "foreigner" is someone residing outside China, except that Chinese nationals temporarily residing abroad are excluded. *Id.*

tered into a Memorandum of Understanding with China in relation to joint supervision of the listing and issuing of shares.[160] The CSRC focuses on maintaining control of its companies and markets and finds unacceptable the notion that a foreign exchange could regulate Chinese companies when they are listed on that foreign exchange.[161] Accordingly, there is no equivalent to Regulation S that relaxes the regulatory requirements for foreign issued shares.[162]

The CSRC reaches further and regulates extraterritorially based on the nature of the shares and the nationality of the purchaser, rather than focusing on the geographical location of the transaction.[163] Shares in China are generally grouped into categories solely for the ideological purpose of maintaining the leading role of government in the economy by compelling state and public organizations to hold the majority of shares.[164] Each category has specific listing and offering restrictions as well as restrictions regarding the residence of the purchasers.[165] Residency is determined by race; thus Chinese nationals residing overseas temporarily are considered residents of China for investment purposes.[166]

There are four categories of shares: A, B, H, and N. "A" shares include state shares, enterprise shares, employee shares, and public shares.[167] They can only be subscribed for, traded in, and purchased by Chinese residents, who are not permitted to invest in foreign stocks.[168] "B" shares are issued only to foreign investors and may not be purchased by Chinese residents.[169] There are also "N" shares and "H" shares, both of which can be

160. *Id.* At present, these are Hong Kong, the U.S., Singapore, and the London Stock Exchange.

161. *Id.* at 84–85.

162. *Id.*

163. *Id.*

164. *See* William I. Friedman, *One Country, Two Systems: The Inherent Conflict between China's Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT'L L. 477, 495 (2002).

165. TOKLEY, *supra* note 155, at 84–85.

166. *Id.* at 82.

167. FINANCIAL REGULATION IN THE GREATER CHINA AREA, *supra* note 124, at 103.

168. TOKLEY, *supra* note 155, at 71.

169. *Id.*

purchased by foreign investors.[170] The "N" shares are issued by Chinese enterprises and listed on U.S. stock exchanges; they are issued only to non-Chinese residents.[171] "H" shares are issued by mainland Chinese enterprises and listed in Hong Kong.[172] Cross-trading between the different share classes is not allowed. This share structure enables the Chinese government, wary of allowing foreign companies access to its domestic securities markets, to limit foreign investment and control its economy.[173]

The Chinese regulatory system contradicts the SEC's stated intent not to regulate wholly extraterritorial securities transactions.[174] While China is better able to control its companies because it has a tighter hold on its issuers, those issuers are also less able to raise foreign capital. Because China's control may hurt its companies rather than facilitate economic success, it may in the future relax its regulation of completely foreign transactions and merge its separate domestic and foreign investments to facilitate company growth.[175] Merging its separate shares – namely class "A" and "B" shares – would allow foreign investors immediate participation in China's securities market and remove the hindrance created by the present segmentation of the market.[176] While it may also be argued that due to the imperfections still within the Chinese markets a separate special share is necessary to facilitate the healthy growth of China's securities markets,[177] China should consider a gradual approach to merger of domestic and foreign shares.[178] Then, when China has adequate and extensive securities laws, developed regulatory bodies, and strong and easily convertible Chinese currency, the shares can be easily merged.[179]

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170. FINANCIAL REGULATION IN THE GREATER CHINA AREA, *supra* note 124, at 103–04.
171. TOKLEY, *supra* note 155, at 72.
172. FINANCIAL REGULATION IN THE GREATER CHINA AREA, *supra* note 124, at 104.
173. *See* Friedman, *supra* note 164, at 496.
174. *See* notes 28–41, *supra*, and accompanying text.
175. TOKLEY, *supra* note 155, at 80.
176. FINANCIAL REGULATION IN THE GREATER CHINA AREA, *supra* note 124, at 108.
177. *Id.*
178. *Id.*
179. *Id.*

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If China seeks to experience continued economic growth, then it will likely be forced to open its market to greater privatization and less government interference. This will foster an economic structure in which the private sector, not the state, owns a majority interest in the nation's enterprises.[180] It will, however, require the CSRC to relinquish some of its tightly-held control over Chinese companies in order to promote foreign investment. China's economy and markets could profit from a system more akin to the U.S. regulatory system where the benefits of regulation are furthered by a flexibility that can accommodate dynamic changes in the capital markets.[181] Like Regulation S, this would enable issuers to raise capital abroad, exerting a positive influence over the domestic market.[182] The Chinese regulatory scheme, however, thwarts this by dividing shares into separate domestic and foreign classes, thus bifurcating the market system and inhibiting foreign investment. If the Chinese government continues to pursue a policy of government interference, its securities markets may ultimately fail.[183]

VI. CONCLUSION

Of the three securities regulatory systems this Note has analyzed, none is perfect. As long as there are regulations, there will be abuses and room for improvements. However, as compared to the British and Chinese systems of securities regulation, the U.S. system is best at balancing investor protection with the ability to raise capital. While it is more difficult after the Regulation S amendments to raise capital abroad, it is also more difficult to abuse the regulation. The SEC has thus struck a fine balance of regulation and freedom through its territorial approach and its improved Regulation S. This combination of regulatory scheme and regulation allows companies to prosper by raising foreign capital while providing adequate protection to the investor. China and the U.K. have, thus far, been unable to achieve this delicate balance.[184]

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180. For a thorough discussion, *see* Friedman, *supra* note 164, at 479–80.

181. *See* Integration of Abandoned Offerings, Securities Act Release No. 7943, 74 SEC Docket 571 (Jan. 26, 2001)

182. Choi, *supra* note 118, at 678.

183. *See* Friedman, *supra* note 164, at 480.

184. Of course, it may be argued, especially as to China, that they do not wish to strike such a balance.

Moreover, the U.S. territorial approach, as compared to the U.K. modified territorial approach, increases the SEC's ability to effectively regulate the securities industry. The SEC's focus on the offshore transaction itself in addition to the place of both the buyer and the seller is a more thorough regulatory scheme; and because the SEC operates within a centralized system, rather than a decentralized system heavily dependent upon self-regulation, like the U.K., it is better able to apply and enforce its regulatory scheme. Effective enforcement is the bedrock of investor protection.[185] In this respect as well, the U.S. has been more successful than its international counterparts.

Nonetheless, the U.S. approach to extraterritorial regulation could be improved by modifying Regulation S to reflect some of the advantages of both the British and Chinese systems. For example, the Regulation S exemptions could be based in part on the geographic location of the offering similar to the way China regulates based in part on cooperation from the foreign country wherein the offering is made.[186] This modification would also borrow from the U.K. system wherein it is left to the discretion of the regulatory body to determine if, and how extensively, an issuer offering abroad is subject to domestic regulation. This modification would advance the SEC's goal to protect investors in U.S. markets by ensuring that inherently risky securities are not quickly sold back into the U.S. At present, the SEC achieves this goal by subjecting securities to U.S. registration requirements. This risk, however, would also be reduced just as effectively by ensuring that the country in which the offshore offering is made is adequately regulating securities offerings. Modifying Regulation S to consider the market in which the offshore offering is being made reduces the need for restricting resales.[187] By removing the resale restrictions, the SEC would be eliminating the potential detriment to domestic investors due to the reduced price of the securities which can only be bought and sold abroad.

Such modifications to Regulation S would also promote international cooperation among securities regulators. This would act to strengthen the securities regimes of all countries as applied to their own issuers and would provide greater

185. FISHMAN, *supra* note 126, at 227.

186. China has memoranda of understanding with many foreign securities exchanges. *See* note 160, *supra*, and accompanying text.

187. Choi, *supra* note 118, at 743.

plied to their own issuers and would provide greater investor protection worldwide.[188] Through this information exchange, regulators could also assist each other in collecting information on fraudulent activities and on better enforcement of securities regulations as a whole.[189] A system of international securities cooperation would even promote seemingly adverse regulatory goals. For example, such cooperation would provide China with greater control over its own companies issuing abroad while at the same time promoting capitalistic markets. Not only would U.S. investors benefit from such a modification to Regulation S, but investors worldwide would experience increased protections. In time, such a regulatory scheme could become the most useful tool in today's global economy.

Jaime M. Jackson[*]

188. *Id.* at 744.

189. The U.S. has already entered into a number of memoranda of understanding with different countries regarding insider trading investigations and enforcement. *See* Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism, and Functionalism: A Comparison with Reference to Securities Regulation*, 4 TRANSNAT'L L. & CONTEMP. PROBS. 69 (1994).

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DEVELOPMENT OF COPYRIGHT PROTECTION IN KOREA: ITS HISTORY, INHERENT LIMITS, AND SUGGESTED SOLUTIONS

I. INTRODUCTION

Korea, the world's eleventh largest economy, is the U.S.'s sixth largest market for international trade.[1] With the advent of a globalizing economy, the two countries have sometimes experienced hostile trade relationships. Most recently, such a conflict has surfaced in the area of copyright protection. With the American influence, the World Trade Organization ("WTO") Agreement on Trade-Related Aspects of Intellectual Property Rights ("TRIPs" or "TRIPs Agreement")[2] has been and continues to be the major source of impact on intellectual property system in Korea. In particular, because Article 4 of the TRIPs Agreement adopts the most-favored nation ("MFN") principle,[3] the interplay between TRIPs and MFN continues to have a significant impact on copyright protection in Korea.

Despite the direct and indirect influence the U.S. had on the development of copyright protection in Korea, cultural and legal differences between Korea and the U.S. have limited such influ-

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1. *See Remarks by Ambassador Thomas C. Hubbard at the Korean Chamber of Commerce and Industry*, United States Embassy, Seoul, Korea (Oct. 26, 2001), *available at* http://usembassy.state.gov/seoul/wwwh010w.html. *See also* Trade and Economy: Data and Analysis, Int'l Trade Adm., U.S. Dep't of Commerce, *available at* http://www.ita.gov/td/industry/otea/usfth/aggregate/h01t58.html.

2. Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, Legal Instruments — Results of the Uruguay Round vol. 31 (1994), 33 I.L.M. 81 (1994) [hereinafter TRIPs Agreement]. For congressional approval of the TRIPS and WTO Agreements, see Uruguay Round Agreements Act, Pub. L. No. 103-465, §§ 101–103, 108 Stat. 4809, 4814–19 (1994) (codified in scattered sections of 15, 17, 19, and 35 U.S.C.).

3. MN principle requires that the same treatment be given to all foreign producers of like products that is given to producers from the MN countries. *See* Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, art. II, Legal Instruments — Results of the Uruguay Round vol. 1 (1994), 33 I.L.M. 1125 (1995); General Agreement on Trade in Services, Dec. 15, 1993, art. IV, 33 I.L.M. 44; Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, 33 I.L.M. 1197.

ence. As Korea is ready to open its legal market to foreign law firms in 2005[4] and the volume of international trade in intellectual property products and human capitals ever abound, development of Copyright law in Korea is of substantial importance for American legal practitioners and academics. To identify the barriers to intellectual property protection in Korea, it is essential to gain a clear understanding of how cultural, legal and historical variables determine the progress and limits of copyright protection in Korea. Accordingly, this Note examines these three factors in relation to the development of copyright protection in Korea. Part II examines the development of copyright law in Korea in a historical perspective and suggests that its cultural and legal systems have been the major determinants of the development of copyright protection in Korea. Part III examines how the external influences such as U.S. law and executive actions permitted under Section 301 of the Trade Act of 1974 and international copyright conventions have impacted the development of Korean Copyright law. Part IV explores the limits in enforcement of copyright protection in Korea and suggests potential solutions to these problems. The Note concludes that, while external international pressures have been effective in the development of the copyright protection system in Korea, because of Korea's deeply laden socio-cultural value system that has not fully immersed into the Korea psyche, the concept of "right-based" notion of copyright, educating the Korean public about the importance of copyright protection, with the help of the international community, would provide the ultimate solution to the problems of Korean copyright protection identified in this Note.

4. "Korea must open its legal market by the end of the next World Trade Organization round in 2005." *UK Lawyers Lobby Korea to Open Legal Market*, N.Y. LAW., Feb. 20, 2002, *at* http://www.nylawyer.com/new/02/02/022002a.html. *See also* Legal Market: South Korea, Legal 500.com, *at* http://www.legal500.com/as500/edit/sk3.htm.

II. HISTORICAL OVERVIEW OF COPYRIGHT LAW DEVELOPMENT IN KOREA

A. Evolution of Intellectual Property in Korean

Despite its long history,[5] Korea's current system of democratic government, capitalist economy and popular culture only came about less than a half-century ago.[6] Although Korea has taken a near quantum leap in modernization process,[7] its old values still underlie virtually all aspects of Korean society. Accordingly, to understand barriers limiting protection of intellectual property in Korea, it is first necessary to examine how the cultural and intellectual tradition of Korea has influenced the evolution of its copyright protection practice.

The inherent cultural limit that imposes a significant barrier to effective enforcement of copyright legislation in Korea can be traced back to its social structure during the Yi Dynasty.[8] For centuries, even the concept of copyright was nonexistent in Korea because publication and distribution of print material was strictly controlled by the government. Even at times of liberalization of publication, publication was monopolized by noble class.[9] While Korea surpassed Japan and even China in certain areas of technological development from the 13th through 16th centuries,[10] its rigid social hierarchy system during these peri-

5. Korea's history dates back to approximately 2500 B.C. *See* History of Korea, *at* http://ist-socrates.Berkeley.edu/~korea/history.htm.

6. Korea was under monarchy until 1910 when Japan annexed Korea. Japanese annexation of Korea lasted until 1945 when Japan was defeated in the World War II. In 1948, Republic of Korea was founded. For the first time in its history, Korea took a modern form of democratic government with the political support from Washington, D.C.

7. Shortly after Republic of Korea was born, the Korean War broke out in 1950, splitting the country into the Democratic South and Communist North. From 1960's through 1980's, South Korea's economy made extraordinary progress, which in turn drastically changed the cultural and social landscape of the country.

8. Yi Dynasty lasted from 1396–1907.

9. *See* SEUNG-HUN HAHN, CHOJAKKWON UI POPJE WA SILMU [Copyright Law and Practice] 25 (1988).

10. The movable type of the printing press was invented in Korea in the early 13th century, more than a century before the Guthenburgh print. However, print was not used by the general public until the late 19th century. The printing press was used to publish official documents for dissemination among a select few in the government. *See* Sang-Hyun Song and Seong-Ki Kim, *The*

ods significantly impeded dissemination of information. For example, the government during the Yi Dynasty era from the late 14th century to the early 20th century controlled book printing and publishing as a special privilege limited to those authorized by the state.[11] As a consequence, few Koreans had an opportunity to appreciate copyright in its practical sense.[12]

Furthermore, until recently, socio-cultural influence of the Confucian value system,[13] which tends to devalue the materialistic compensation of the literati, significantly undermined development of copyright protection in Korea. A Korean legal commentator argued:

> Those engaged in scholarly and artistic professions avoided the monetary disputes over their published works because they traditionally valued the spirit of nobility until recent years as members of the cultural elite in our country. As a result, the right-consciousness with respect to copyright did not pervade the general public in Korean society.[14]

B. Development of Korean Copyright Act

1. Yi Dynasty: 1396 - 1907

In 1884, copyright was first mentioned as "chulpankwon" (literally, "publishing right") in Hansung Sunbo, a newspaper published by the government of the Yi Dynasty.[15] "This right is designed to authorize the government to prevent others from

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Impact of Multilateral Trade Negotiations on Intellectual Property Law in Korea, 13 UCLA PAC. BASIN L.J. 118, 120, n. 10 (1994).

11. *See* HAHN, *supra* note 9, at 25.

12. The governmental licensing of the printing press in premodern Korea is similar to the politically motivated tactic employed by the Crown in England during the 14th and 15th centuries. *See* PAUL GOLDSTEIN, COPYRIGHT'S HIGHWAY 38, 40 (1994).

13. Confucian value system which emphasizes social harmony based on hierarchy has had significant influence on all aspects of Korean society including its legal system and social values. *See* Hyu-Chong Park, *Confucianism and Korean Communitarianism*, Seoul National University, *at* http://aped.snu.ac.kr/cyberedu/cyberedu/cyberedui/eng/eng24-01.htm.

14. YONG-SIK SONG, PROBLEMS WITH THE CURRENT COPYRIGHT LAW (I), 19 PYONHOSA [Lawyer] 181, 182 (1989). *See also* HAHN, *supra* note 9, at 25 (stating that the "traditional Confucian spirit of the nobility in Korea led Koreans to hesitate in accepting payment for their published works").

15. JEON YOUNG-PYO, CHONGBO SAHOE WA CHOJAKWON [Information Society and Copyright] 105 (1993) (citing HANSUNG SUNBO, Feb. 1, 1884, at 18).

copying the books written and the foreign books translated by intelligent and talented people," read the Hansung Sunbo news article.[16] "By allowing only the authors the right to print and sell their books, it enables them to profit from their books and translations and at the same time to make efforts to enlighten their society." [17]

2. Japanese Occupation Period: 1908-1945

Koreans' exposure to the concept of copyright was followed by a legal recognition of copyright through a treaty between the United States ("U.S.") and Japan in 1908.[18] The U.S. and Japanese treaty on Protection of Industrial Property in Korea provided that the Japanese statutes on copyright and other related rights be applied in Korea.[19] As a result, the Treaty guaranteed the equal protection of copyright to Americans as to Koreans and Japanese, and the Copyright Act of Japan was "borrowed" by the royal government of the Yi Dynasty in accordance with Imperial Ordinance No. 200 on copyright.[20] After the Japanese annexation of Korea in 1910, it is not clear how and to what extent the Japanese colonial government enforced its copyright law in Korea. However, it is most likely that copyright was not a major concern to the Japanese colonial rulers because Korea was not culturally ready to recognize copyright as a right. This is hardly a surprise considering that copyright did not directly affect the predominant "peace and order" goal of the Japanese colonial government in pushing legal reforms in Korea.[21]

3. Korea Copyright Act of 1957

Copyright was recognized as a right in 1948 when the Constitution of the First Republic of Korea was proclaimed.[22] The

16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. SONG, *supra* note 14, at 182–83.
21. *See* EDWARD J. BAKER, THE ROLE OF LEGAL REFORMS IN THE JAPANESE ANNEXATION AND RULES OF KOREA, 1905–1919, *cited in* SANG-HYUN SONG, KOREAN LAW IN THE GLOBAL ECONOMY 76, 98 (1996).
22. "All citizens shall have freedom of science and art. Rights of authors, inventors, and artists shall be protected by it." HONBOP [CONSTITUTION] art.

Constitution of 1948 did not use the word "copyright" but provided the basis for it.[23] However, under Ordinance No. 21 of the U.S. Army Military Government (1945-1948) in Korea, the Copyright Act of Japan continued to be used by the Korean government until 1957. This is especially noteworthy since the 1908 U.S. copyright treaty with Japan for reciprocal protection in Korea of copyright and trademarks as well as designs and inventions became obsolete after World War II.[24] The first Korean copyright statute was established in 1957, modeled after the 1899 Copyright Act of Japan.[25]

The Copyright Act of 1957 ("the Act") was formulated to promote the Korean culture by "protecting the authors of academic or artistic works."[26] The works to be protected under the Act included written and oral works, paintings, sculpture, fine art, architecture, maps, schematic drawings, photographs, musical works, drama, phonographs, cinema and things which belong to the academic and artistic categories.[27] The statute did not apply to: (1) Laws, regulations, decisions and orders of government agencies, and the texts of official documents, except for those "confidential" documents for internal use; (2) News of current events; (3) Miscellaneous information published in newspapers or magazines; (4) Public testimonies during the open

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14 (1948), *translated in* 2 Constitutions of Nations 549–59 (Amos J. Peaslee ed., 2d ed. 1956).

23. *Id.*

24. Charles I. Bevans, 9 Treaties and Other International Agreements of the United States of America 1776–1949, at 408 (1972). *See* Treaties in Force 483 n.19 (1997).

> Copyright convention with Japan for reciprocal protection in Korea of inventions, designs, trademarks, and copyrights, signed at Washington, May 19, 1908 (TS 506). This convention is considered as having been abrogated on April 8, 1951 (TIAS 2490), since it was not included in the notification which was given on behalf of the United States Government to the Japanese Government on April 22, 1953, indicating the prewar bilateral treaties or conventions which the United States wished to continue in force or revive.

Id.

25. CHOJAKKWONBOP [COPYRIGHT ACT], Law No. 432 art. 1 (1957), *translated in* Laws of the Republic of Korea 806, 806–13 (3d ed. 1975) [hereinafter Copyright Act of 1957].

26. Copyright Act of 1957, art. 2.

27. *Id.*

court proceedings; or (5) the open sessions of the National Assembly or the provincial legislatures.[28]

Copyright included the personal and property rights of the author to his works.[29] That is, regardless of his property right to the work, the author "shall have the right to attribution"; to indicate his identity even after the monetary value to the work was transferred to others.[30] Further, Article 16 stipulated: "The author shall have the right to raise objections to those who injure his reputation by changing the contents and title of his work even after the property right to the work was transferred, irrespective of the property right to his work."[31]

The Act did not require registration of the copyrighted work with the government under the self-operating recognition of the copyrighted work. Copyrights lasted for thirty years in addition to the life of the author.[32] The copyright of translated material was protected for five years.[33] Except when it was first published in Korea, foreigners' work was not protected under the statute unless otherwise stipulated.[34]

The "fair use" concept was recognized to allow use of copyrighted material without violation of the law. The Act specifically allowed: (1) Copying a copyrighted work without using mechanical or chemical means and with no intention of publication; (2) Appropriately quoting from a copyrighted work; (3) Appropriately quoting illustrations in textbooks; (4) Using phrases from scholarly or artistic works as insert into a play or as supplement to a musical work; (5) Inserting scholarly or artistic works as explanatory material for other works; (6) Making drawings of sculptural work and vice versa; (7) Performing dramatic or musical works in public for educational purposes, and broadcasting of the performance; and (8) Using phonorecords, taped cassettes, and films for public performance or broadcasting.[35]

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28. *Id.* art. 3.
29. *Id.* art. 7.
30. *Id.* art. 14.
31. *Id.* art. 16.
32. Copyright Act of 1957, 30(1).
33. *Id.* art. 34(1).
34. *Id.* art. 46.
35. *Id.* art. 64(1).

4. 1986 Amendment to the Korea Copyright Act

The Act, amended in 1986,[36] protects the right of authors to ensure the improvement and development of culture in Korea. Compared with the previous Act, the Copyright Act of 1986 extends protection of the copyrighted work from thirty years to fifty years past the death of the author, and the copyright on a work created by two or more authors extends through the life of the last surviving author plus another fifty years.[37] Work created under employment is distinguished from "work-for-hire." If a person prepares a work within the scope of his employment, the copyright belongs to the employer, not the creator of the work.[38] However, copyright of work made by an independent contractor belongs to the contractor unless otherwise specified in the contract.[39] The Korean law recognizes foreigners' copyright to works under treaties that Korea has signed with foreign countries.[40] However, the treaty is not essential to the copyright protection of foreigners' works. Korean law still considers the residency status of foreigners and the initial publication of the foreigners' works in Korea.[41] Even when a foreigner's work would be protected, if the foreign country concerned does not protect works of the nationals of the Republic of Korea, the protection under treaties and this Act may be restricted correspondingly.[42]

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36. *See* UNESCO, *Republic of Korea: Copyright Act 1986*, *available at* http://www.unesco.org/culture/copy/copyright/republicofkorea/sommaire.html.

37. *Id.* art. 36.

38. *Id.* art. 9. Article 9 reads:

> [T]he author of a work which is prepared on duty by a person working or a juristic person under the direction of a corporation, organization, or other employer . . . and which is published in the name of the juristic person, . . . shall be the juristic person, . . . unless otherwise provided by employment or independent agreement.

39. *Id.*

40. *Id.* art. 3 (1).

41. Article 3 (2) provides:

> [W]orks of a foreigner who has his habitual residence in the Republic of Korea (including foreign juristic persons having the principal office in the Republic of Korea . . .) and foreigners' works which are first published in the Republic of Korea (including works published in the Republic of Korea within 30 days after publication in a foreign country) shall be protected under this Act.

42. *Id.* art. 3 (3)

A broad categorization of works are protected by the Copyright Act of 1986. Among those listed in the statute are: (1) linguistic and literary works; (2) musical works; (3) theatrical works; (4) art works; (5) pictorial works; (6) motion pictures; and (7) computer program works.[43] The list is distinguished from that of the 1957 Act in that the kinds of work protected under the amended Act cover the entire scope of intellectual and cultural activity including computer program works. Similar to the U.S. law,[44] the Copyright Act of 1986 reestablished the "fair use" of copyrighted work as a limitation to the copyright of the owner. Unlike the Copyright Act of 1957, the amended Copyright Act of 1986 emphasized, by listing in detail, each category of Article 64 in the Copyright Act of 1957 under each Article in the amended Copyright Act of 1986. For example, Article 22 states that if it is necessary for the judicial proceedings or for internal material or legislative or administrative purposes, any work may be reproduced for such purposes unless it infringes unreasonably on the interest of the author's property right owned in light of the nature of the work and the number of copies and forms of the reproduction.[45] Further, Article 23 allows the released works to be inserted in textbooks to the degree necessary for educational purposes at schools of the level lower than high schools or the equivalent thereto.[46] In case of reporting current news through broadcasting, motion pictures, newspapers, or other means, any work which is viewed or listened to in the course of such reporting may be reproduced, distributed, performed publicly, or broadcast within the limits proper for such purposes.[47] The Copyright Act does not apply to quotations from released works "within the reasonable limit in conformity with fair practice."[48] The fair use exemptions to copyright, however, do not affect the author's personal right to reputation or privacy.[49] Finally, most notable accomplishment of the Copyright Act 1986 is establishment of *The Copyright*

43. *Id.* art. 4.

44. For the U.S. Supreme Court's interpretation of the "fair use" doctrine in American copyright law, see *Harper & Row Publishers, Inc. v. Nation Enterprises*, 471 U.S. 539 (1985).

45. Copyright Act of 1986, *supra* note 36, art. 22.

46. *Id.* art. 23(1).

47. *Id.* art. 24.

48. *Id.* art. 25.

49. *Id.* art. 35.

Deliberation and Conciliation Committee ("CDCC"), which mediates copyright disputes involving compensation, rates, and fees of copyright agents.[50]

5. 1997 Amendment to the Korea Copyright Act

The Korea Copyright Act was amended again in 1997.[51] Like its predecessor, the current Act protects an author's "moral rights" as part of his personal rights to his work. The moral rights, which the Berne Convention[52] recognizes, focus on the author's right to claim "paternity" and to protect the "integrity" of his work. The "paternity" element of the "moral rights" is "the author's right to be made known to the public as the creator of his work, to prevent others from usurping his work by naming another person as the author, and to prevent others from wrongfully attributing to him a work he has not written."[53] Moral rights are not limited to the author's interest in protecting the "paternity" and "integrity" of a work. They sometimes "encompass the right to publish or not to publish a work, to withdraw a work from sale, and to prevent other injuries to the author's personality as embodied in the work."[54]

The statute provides for the author's right to decide on publication of his work and for his right to identify his authorship by his real name or pseudonym on the original or reproductions of his work. The integrity of the author's work is also included in

50. *Id.* art. 82. *See also* CECE website *at* http://www.copyright.or.kr:8080/introduce/int_b_history.htm.

51. 1997 Copyright Act of Korea, Act No. 5453, Dec. 13, 1997, *available at* http://www.copyright.co.kr [hereinafter Copyright Act of 1997].

52. The Berne Convention, last revised in Paris in 1971, provides for the author's "moral rights" as follows:

> Independently of the author's economic rights, and even after the transfer of the said rights, the author shall have the right to claim authorship of the work and to object to any distortion, mutilation or other modification of, or other derogatory action in relation to, the said work, which would be prejudicial to his honor or reputation.

Berne Convention for the Protection of Literary and Artistic Works, July 24, 1971, art. 6bis(1). For a discussion of the "moral rights" under the Berne Convention, see S.M. STEWART, INTERNATIONAL COPYRIGHT AND NEIGHBOURING RIGHTS §§ 4.39–4.45 (2d ed. 1989).

53. RALPH S. BROWN & ROBERT C. DENICOLA, CASES ON COPYRIGHT, UNFAIR COMPETITION, AND OTHER TOPICS BEARING ON THE PROTECTION OF LITERARY, MUSICAL, AND ARTISTIC WORKS 717 (7th ed. 1998).

54. *Id.* at 708–709

the statute.[55] The author's moral rights belong exclusively to the author himself and do not abate with the death of the author.[56] The most remarkable amendment in the Copyright Act during 1990s is the strengthening of the penal provision for infringement of the copyright. Compared with its counterpart in the Copyright Act of 1987, Article 98 of the Copyright Act of 1997 increased the maximum amount of the criminal penalty for infringement of copyright from three years' imprisonment and 3 million won (USD 2,500)[57] to three years imprisonment and 30 million won (USD 25,000).[58] In addition, the maximum penalty for illegal publication is also increased from one year's imprisonment and 1 million won (USD 800) to one year's imprisonment and 10 million won (USD 8,000).[59]

6. 2000 Amendment to the Korean Copyright Act

Most recently, the Korean Copyright Act was amended in 2000. This resulted in certain improvements of copyright protection and related procedures. First, the amendment's provision concerning registration of copyright has been significantly improved in terms of providing procedures needed for registration of copyright. Unlike the 1997 amendment which only provided vague procedures for registration of copyright, the 2000 amendment provides detailed, coherent and systematic steps in

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55. Article 13 states:

> (1) The author shall have the right to maintain the identity of contents, form, and title of his work; (2) The author shall not make an objection to a modification falling under any of the following subparagraphs unless essential contents are changed: 1. In the case of a work being used under Article 23 [use for purpose of school education], a modification of expression within limits as deemed inevitable for the purpose of school education; 2. Expansion, remodelling, and other forms of transformation of a building; and 3. Other modifications within limits as deemed inevitable in view of the nature of a work or the object or form of its use

56. Copyright Act of 1986, *supra* note 36, art. 14 (1).

57. Korean currency is the *won*: one U.S. dollar is approximately equal to 1,200 won.

58. *Compare* Copyright Act of 1986, art. 98, *with* Copyright Act of 1997, art. 98.

59. *Compare* Copyright Act of 1986, art. 99, *with* Copyright Act of 1997, art. 99.

registering copyright.[60] Second, the 2000 amendment strengthened the Act's penal provisions, increasing the maximum penalty for infringement of authors' "property rights" from three years' imprisonment and 30 million won (USD25,000) to five years imprisonment and 50 million won (USD40,000).[61] Finally, the 2000 amendment provides for a right of electronic transmission in accordance with the WIPO Copyright Treaty as well as "reproduction compensation system" to ensure payment of renumeration by copier machine makers and users."[62]

C. Recent Progress in Judicial Review in Korean Copyright Cases

1. Korean Supreme Court Case

In the course of interpreting the Copyright Act for the past ten years, Korean courts have set the conceptual and legal framework of copyright as a right in Korea. The Supreme Court of Korea ruled on the "originality" of works as a requirement for protection of the works under copyright law. The Supreme Court stated:

> To be eligible for protection under the Copyright Act, a work must be original with respect to literature, science, or arts (Article 2(1) of the Copyright Act) and creativity is required as an element of its copyright protection. But creativity referred to here does not mean originality in its perfect sense. Rather, it means only that the work is not a mere imitation of someone else's work and that it contains the expression of the author's individual ideas and feelings. To meet this requirement, it is sufficient that the work has the unique characteristic of the author's mental efforts and is distinguishable from the existing works of others.[63]

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60. 2000 Korean Copyright Act, Act No. 6134, Jan. 12, 2000, arts. 51–53, found in Statutes of the Republic of Korea, Vol. 7 [hereinafter Copyright Act of 2000].

61. *Id.* art. 97-5

62. *See* Copyright Act of 2000, arts. 18–2 & 27. *See also* Jay (Young-June) Yang, Hye-Suk Wee and Jae H. Kim, Kim & Chang, Seoul, Korea, *Recent Developments in IP Law in Korea*, *available at*, http://www.asialaw.com/directories/ipprofiles 2000/korea.

63. *Chong Dae-yong v. State*, 94 to 2243, Taebopwon [Supreme Court] (Nov. 14, 1995), Panrae kongbo [Official Gazette of Court Decisions] 117–19 (Jan. 1, 1996).

The Korean Supreme Court's notion of "originality" as the *sine qua non* of copyright protection is similar to the U.S. Supreme Court's standard for the creativity of copyrighted works under American law. The U.S. Supreme Court in *Feist Publications, Inc. v. Rural Telephone Service Co.*[64] held: "Original, as the term is used in copyright, means only that the work was independently created by the author (as opposed to copied from other works) and that it possesses at least some minimal degree of creativity . . . To be sure, the requisite level of creativity is extremely low; even a slight amount will suffice."[65]

Similar to U.S. copyright law,[66] the Korean law follows the principle that expressions are copyrightable, while ideas are not. The Supreme Court of Korea held:

> A work under the Copyright Act must be a creative expression of the author's thinking and feelings acquired through an individual's efforts. Accordingly, what is protected by the Act is the author's creative means of expressing his thinking and feelings to the public by way of speech, language, sounds, or color. Although the contents or ideas expressed . . . may be creative and novel in their own way, they . . . cannot be copyrightable work and thus cannot be entitled to protection as part of the author's personal or property rights.[67]

After all, what is protected by the Copyright Act is not the author's ideas but their expressions and it is limited to the individual aspect of the author's originality. Accordingly, a determination of whether a copyright was violated must be based on the rule that a substantial similarity between the two works at issue should concern their original expressions.[68]

The idea-expression distinction explains why copyright law does not condition its protection of a work on its contents. The

64. *Feist Publications, Inc. v. Rural Telephone Service Co.*, 499 U.S. 340 (1991).

65. *Id.* at 345 (citation omitted).

66. *See Baker v. Seldon*, 101 U.S. 99 (1879) (making a distinction between protected expressions and unprotected ideas under copyright law).

67. *Kim Song-gi v. Sin Sa-hun*, 93 Ta 3073, 3080, Taebopwon [Supreme Court] (June 8, 1993), 41(2) Taebopwon panraejip [Supreme Court Decisions] 103 (1993) (emphasis added). For a discussion of *Kim Song-gi v. Sin Sa-hun*, see Sim Chang-sop, Copyright Owner in the Case of Producing Applicational Art Work by Order, 19(2) Taebopwon panrae haesol [Commentaries on Supreme Court Decisions] 390–408 (1993).

68. *See Kim Song-gi, supra* 67*,* at 105.

Supreme Court of Korea has upheld copyright even where the work's content is considered "immoral" or "illegal."[69] This parallels the statutory and judicial approach to the copyright and morality issues in the U.S. An American legal scholar noted: "The 1976 Copyright Act nowhere bars protection because of the perceived illegality or immorality of a work's content. Contemporary courts have generally declined to imply any such bar into the Act, and have sustained copyright against charges that a work's obscene . . . content precluded relief for infringement."[70]

2. *Educational Testing Service v. Seiyang Planning Inc*.[71]

Of a notable importance is a copyright case adjudicated by the Seoul District Court involving the Educational Testing Service ("ETS"), the American company in charge of supervising the *Test of English as a Foreign Language* ("TOEFL") in about 170 countries. ETS sued in Seoul Civil District Court, seeking damages against a Korean company for copyright infringement.[72] This case originated from ETS's claim that the defendant company published a book using TOEFL test questions.[73]

The defendants argued, relying on the "quotation from released works" clause of the Copyright Act, that their act of quoting the questions of the "released" TOEFL for its TOEFL review book did not infringe on the ETS copyright. They maintained that they could quote the tests for educational purposes within the reasonable limits in compliance with the fair practice of quoting under the law.[74]

The Seoul Civil District Court rejected the defendants' argument based on "released works" under the Copyright Act. The court defined the "release" of a work as "presenting" the work "to the general public through public performance, broadcast-

69. *See Yi Chong-suk v. Yi Chae-gil*, 90 Taka 8845, Taebopwon [Supreme Court] (Oct. 23, 1990), 38(3) Taebopwon panraejip [Supreme Court Decisions] 7–20 (1990).

70. PAUL GOLDSTEIN, 1 Copyright, § 2.5.1, at 2:40–2:41 (2d ed. 1997) (citations omitted).

71. 92 Kahap 35610, Seoul Minsa Chibang Popwon [Seoul Civil District Court] (Oct. 15, 1993), 3 Hagupsim pangyoljip [Lower Court Decisions] 243 (1993) [hereinafter ETS].

72. *Id.*

73. *Id.*

74. *Id.* at 248–49.

ing, display, or by any other means, and to publish [its] work."[75] The mere fact that the TOEFL tests were given to a limited number of students could not constitute the "release" of the tests under the law. The court emphasized ETS's policy of disallowing students from keeping or circulating the tests and of retrieving the copies of the tests after the tests.[76]

The Seoul Civil District Court ruled that ETS should recover the damages equivalent to the amount of profits that ETS would ordinarily make from its rights to the TOEFL questions, whether they were published or not.[77] The Court awarded ETS USD39,400 in damages against the Korean defendants for their violation of the ETS copyright to the TOEFL questions. Noting that each published TOEFL question would be worth USD 10 in profits to ETS, the court calculated the damages based on the possible profits that ETS might have earned from the total of 3,940 TOEFL questions that the Korean defendants published illegally.[78]

Nevertheless, the Seoul court rejected the ETS's USD47,891 damages claim for its alleged expenditure in creating new questions for a make-up test which was required for those who took the previous tests with the same questions that the defendants had published. The court argued that the defendants did not expect ETS to use the questions they had copied for publication in its actual TOEFL, let alone the "special damage" that ETS would suffer in arranging for the retaking of the tests with new questions.[79] ETS did not include in its damages claim the possible profits of the Korean defendants that were attributable to their infringement of its TOEFL copyright.

III. SOURCES OF EXTERNAL INFLUENCES ON KOREAN COPYRIGHT LAW

A. Impact of U.S. Law and Executive Actions on Korean Copyright Law

While increase in global economic activities and demand for domestic industry protection have created a conducive envi-

75. *Id.* at 249.
76. *Id.*
77. *Id.* at 251.
78. *Id.*
79. *Id.*

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ronment for copyright protection in Korea, U.S. law and their executive actions have had a substantial impact on recent development in Korean copyright law. Section 301 of the Trade Act of 1974, in particular, had the initial impact.[80]

Section 301 confers upon the President broad discretionary power to impose retaliatory actions against foreign governments when he finds that their "act, policy, or practice" is (1) "inconsistent with . . . or otherwise denies benefits to the United States under any trade agreement," or (2) "unjustifiable, unreasonable, or discriminatory and burdens or restricts United States commerce."[81] Section 301 is unusual in that it not only provides the President authority to enforce powerful executive actions,[82] but also allows "[a]ny interested individuals" to peti-

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80. *See* Trade Act of 1974, §§ 301–06 (codified at 19 U.S.C. §§ 2411–2416), as amended, Pub.L. No. 96–39, tit. IX, 93 Stat. 295 (1979); Pub.L. No. 98–573, §§ 304, 306, 98 Stat. 3002 (1984); Pub.L. No. 100–418, §§ 1301–02.

81. 19 U.S.C. § 2411(a) provides:

> If the President determines that action by the United States is appropriate --
>
> (1) to enforce the rights of the United States under any trade agreement; or
>
> (2) to respond to any act, policy, or practice of a foreign country or instrumentality that --
>
> > (A) is inconsistent with the provisions of, or otherwise denies benefits to the United States under, any trade agreement, or
> >
> > (B) is unjustifiable, unreasonable, or discriminatory and burdens or restricts United States commerce;
>
> the President shall take all appropriate and feasible action within his power to enforce such rights or to obtain the elimination of such act, policy, or practice. Action under this section may be taken on a nondiscriminatory basis or solely against the products or services of the foreign country or instrumentality involved.

82. 19 U.S.C. § 2411(b) authorizes the President to:

> (1) suspend, withdraw, or prevent the application of, or refrain from proclaiming, benefits of trade agreement concessions to carry out a trade agreement with the foreign country or instrumentality involved; and
>
> (2) impose duties or other import restrictions on the products of, and fees or restrictions on the services of, such foreign country or instrumentality for such time as he determines appropriate.

Section 301 also reaches farther than other United States trade laws: (1) Section 301 can be used against foreign government practices that harm U.S.

tion the government to enforce executive actions against foreign governments on their behalf.[83] During the 1980s, the U.S. had effectively utilized Section 301 to pressure developing countries to strengthen their intellectual property law.[84]

In November 1985, the U.S. initiated a Section 301 investigation into the potential adverse impact on the U.S. intellectual property rights as a result of inadequate copyright protection by the South Korean government.[85] Initially, a complaint by U.S. chemical companies having interest in patent protection in Korea triggered the investigation.[86] However, the investigation later encompassed copyright protection issues. For example, the United States Trade Representative ("USTR") commented that Korea's copy right protection is "virtually non-existent."[87] Although the U.S. officials had expected that the initial draft of the Korean Copyright Act of 1986 would provide effective protection of copyrights, especially with regard to computer programs, the draft failed to meet such expectation.[88] U.S. intellectual property owners continued to experience unauthorized reproduction of copyrighted materials in Korea, and the South Korean government's failure to protect the American interest

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exporters in third country markets; (2) Section 301 deals with a greater array of trade-distorting commercial policies, including those affecting services and investment; (3) Section 301's requirement that foreign government practices "burden[ ] or restrict[ ]" United States commerce is much lower than the "material injury" requirement of other United States trade laws; and (4) Section 301 gives the President a broader choice of remedies than other trade laws.

83. 19 U.S.C. § 2412(a) (1982 & Supp. III 1985) provides that:

> Any interested person may file a petition with the United States Trade Representative ("USTR") . . . requesting the President to take action under section 2411 of this title and setting forth the allegations in support of the request. The Trade Representative shall review the allegations in the petition and, not later than 45 days after the date on which he received the petition, shall determine whether to initiate an investigation.

84. *See generally* David I. Wilson, *A Trade Policy Goal for the 1990s: Improving the Adequacy and Effectiveness of Intellectual Property Protection in Foreign Countries*, 1 TRANSNAT'L LAW. 421 (1988).

85. *See id.* at 427.

86. *See id.*

87. *See id.*

88. *See id.*

prompted the USTR to pressure South Korean government and industry with the threat of retaliation.[89]

This Section 301 mechanism activated extensive consultations with the South Korean government, consummating in a settlement agreement in August of 1986.[90] As a result, South Korea agreed to introduce a general copyright bill by July 1, 1987, in which the scope of copyright protection would conform with the standards enumerated in the Universal Copyright Convention("UCC"),[91] and to enact the Computer Program Protection Law explicitly covering computer software.[92] In addition, Korea agreed to accede to the UCC and Geneva Phonograms Convention by October 1987.[93] Accordingly, the 301 action had a direct impact on the passage of the 1986 Korean Copyright Act.

Furthermore, through the mechanism of "Special 301," which the U.S. Congress created when it passed the Omnibus Trade and Competitive Act of 1988, the United States Trade Representative ("USTR") identifies those countries that deny adequate and effective protection of intellectual property rights, and, through annual reports, recommends that these countries be subject to immediate trade sanctions.[94] South Korea is one of

89. GENERAL ACCOUNTING OFFICE, *Strengthening Worldwide Protection of Intellectual Property Rights*, GAO/NSI AD-87-65 (1987) [hereinafter GAO Report].

90. 51 Fed. Reg. 29, 445 (1986).

91. Universal Copyright Convention, Sept. 6, 1952, Geneva, 6 U.S.T. 2731, T.I.A.S. No. 3324, 216 U.N.T.S. 132, revised July 24, 1971, Paris, 25 U.S.T. 1341, T.I.A.S. No. 7868; Convention for the Protection of Producers of Phonograms Against Unauthorized Duplication, Oct. 29, 1971, 26 U.S.T. 309, T.I.A.S. 7808.

92. Press Release, Korean Information Office, Embassy of the Republic of South Korea, Section 301 Cases Finally Settled – Insurance and Intellectual Property Rights, at 6 (July 21, 1986). Under the old Copyright Act of 1957, computer program works were omitted from the list of subject matter for protection. However, the Copyright Act of 1986 protects virtually the entire scope of intellectual and cultural activity. *See* Copyright Act of 1986, *supra* note 36, art. 4(1).

93. Wilson, *supra* note 84, at 428.

94. *See* Special 301, International Intellectual Property Alliance, *available at* http://www.iipa.com/copyrighttrade_issues.html.

> Countries which have the most onerous or egregious acts, policies or practices and which have the greatest adverse impact on relevant U.S. products must be designated "Priority Foreign Countries," and at the end of an ensuing investigation, risk having trade sanctions

the countries whose status of intellectual property protection the USTR watches and inspects annually.

The resulting impact is illustrated in the Act. The Act provides copyright protection for a term of life plus fifty years for works authored by individuals and for a term of fifty years for works authored by juridical persons.[95] It also protects sound recordings made outside of South Korea for a term of twenty years and stringently enforces existing protection of sound recordings against unauthorized reproduction, importation and distribution.[96] The extension of protection to foreign sound recordings and the enactment of the Computer Program Protection Law was to inhibit sound-recording and software piracy by Korean manufacturers.[97] At the time of the post-301 action negotiations, South Korea also pledged to ensure adequate protection of intellectual property rights through strict enforcement of the relevant laws and through public announcements of the administrative rules and regulations affecting the protection of intellectual property rights.[98] However, as discussed below, whether this promise is being enforced is open for debate, and should be further examined.

B. Impact of International Copyright Conventions on Korean Copyright Law

Since the 1986 bilateral agreement between the U.S. and Korea, the U.S.'s impact on the Korean Copyright Act through Section 301 actions has resulted in Korea's accession to multilateral Copyright Conventions[99] and may also cause Korea to

> levied against them. Countries can also be placed on other lists which do not result in immediate trade sanctions, such as "Priority Watch List" and "Watch List." Special 301 is an annual review process which starts when public comments due to USTR in mid-February, with USTR announcing its decisions on April 30.

Id.

95. *See supra* note 37.

96. *Id.*

97. *See supra* note 92, at 2–3.

98. *Id.* at 8.

99. Korea is a signatory to the World Intellectual Property Organization ("WIPO"), the Universal Copyright Convention ("UCC") and the Paris Convention for the Protection of Industrial Property. *See* Going Global : Korea Export Issues, 1997 Export Hot line, *available at* http://home3.americanexpress.com/smallbusiness/ resources/ expanding/glob/11139020.shtm.

become signatory to other similar Conventions. Korea's accession to the international treaties has great significance in that Korea began to recognize the importance of copyright in accordance with the international norm.

1. Berne Convention

The Berne Convention is the world's oldest international copyright convention and provides the highest level of multilateral copyright protection.[100] Although South Korea has not acceded to the Berne Convention, it had an indirect influence on the Korean Copyright Act of 1986 and its 1997 amendments. For example, as discussed *supra* Part II, the concept of moral rights has been incorporated into the Act's provisions, which the Berne Convention recognizes.[101]

A major point of debate between South Korea and the U.S. about the Copyright Act of Korea is retroactive copyright protection, which is based on Article 18 of the Berne Convention. While the U.S. asserts retroactive protection dating back to 1950, as would now be required under the Berne Convention, the Korean government insists on retroactive protection only back to 1957 for national and foreign works.[102] Some argue that "Korea's accession to the Berne Convention has become inevitable."[103]

2. Universal Copyright Convention ("UCC")

As part of the bilateral negotiation with the U.S., in 1987, South Korea joined the UCC (effective Oct. 1, 1987) and the Geneva Phonographs Convention (effective Oct. 10, 1987).[104] While the UCC does provide fairly comprehensive copyright protection provisions, as one commentator noted, there is a

100. John T Masterson, Jr., *Protection of Intellectual Property Rights in International Transactions*, Corporate Law and Practice Course Handbook Series, 863 Practicing Law Inst. 333, 360 (Oct. 1994).

101. *See supra* notes 51–54 (discussing moral rights in the Korean Copyright Act and Berne Convention).

102. *See* International Intellectual Property Alliance, *2001 Special 301 report : South Korea* 222, *available at* http://www.iipa.com/special301_TOCs/2001_SPEC301_TOC.html [hereinafter IIPA 2001 Report].

103. *See* Song & Kim, *supra* note 10, at 130.

104. Joon K. Park, *South Korea*, in INTELLECTUAL PROPERTY LAWS OF EAST ASIA 337, 348–49 (Alan S. Gutterman & Robert Brown eds., 1997).

wrinkle between Korea's accession to the UCC and its future accession to the Berne Convention:

> Because the UCC does not protect works pre-existing on the date of its enforcement in a specific jurisdiction, Korea's primary concern with acceding to the Berne Convention is the interpretation of Article 18, which prescribes protection of works existing at the moment the Berne Convention comes into force. The decision of whether the protection of existing works will be retroactive or not will greatly affect the copyright protection of works by foreign authors in Korea. In addition, rental rights for copyrighted works will have to be carefully reviewed. Although rental rights are required under Article 11 of TRIPs, existing laws do not provide rental rights for computer programs and cinematographic works.[105]

Therefore, one of the central issues of concern for the USTR is whether South Korea would implement a retroactive application provision of the Berne Convention into its Copyright Act in case South Korea does become a signatory to the Berne Convention.

IV. PROBLEMS IN ENFORCEMENT OF COPYRIGHT LAW IN KOREA AND SUGGESTED SOLUTION

A. Current Problems of Copyright Protection in Korea

Korea has made a modest effort to strengthen copyright protection by passing the Copyright Act and Computer Program Protection Act ("CPPA"), which were designed to comply with its obligations under WTO's TRIPs Agreement.[106] Nonetheless, copyright violations have been recurring in Korea and, as a result, Korea has been placed on the Priority Watch List for many years.[107] According to the International Intellectual Property

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105. *See* Song & Kim, *supra* note 10, at 130.

106. USTR, 1996 National Trade Estimate — Republic of Korea, *available at* http://www.ustr.gov/reports/nte//1996/korea.html.

107. According to the Chart of Countries' Special 301 Placement and IIPA 2001 Special 301Recommendation, Korea has been in the list of Priority Watch List except those years when the U.S. government pushed Korean government to implement the stronger enforcement for intellectual property protection. *See* International Intellectual Property Alliance, *2001 Special 301 report: Appendix D, available at* http://www.iipa.com/pdf/2001_special301 AppendixD.pdf [hereinafter IIPA 2001 Report, App. D]. In Spring 2000, for example, Korea was elevated to Special 301 "priority watch list" from "watch

Alliance ("IIPA"), Korea's copyright law amendments did nothing to eliminate a clear and long-standing discrepancy between Korean law and the requirements of TRIPs Agreement.[108] For example, under the Article 18 of Berne Convention and the Article of 14.6 of the TRIPs Agreement, existing works and sound recordings not previously protected in a WTO member country must be protected retroactively for the full term of protection (fifty years, or life plus fifty years) even if the work or sound recording has not fallen into the public domain in the country of origin through the expiration of the term of protection.[109] However, Korea's transition rules do not protect foreign works whose authors died before 1957 and, thus, fail to comply with the TRIPs Agreement.[110] Under the transitional rules, producers of pre-1995 derivative works of newly protected foreign works were allowed to reproduce and sell those works until the end of 1999, without paying any compensation to the copyright holder.[111] Such reproduction practices are incompatible with the transition rules under the Article 18(3) of the Berne Convention and, thus, would permit continued exploitation of the copyright holder.[112]

In addition, there are also continuing concerns over the legislation, including the issue of reproduction in libraries.[113] The IIPA highlights the potential infringement of international copyrights related to p roduction in libraries:

> Article 28 (1) allows libraries and similar institutions to digitize entire works or sound recordings without permission, and to give copies to patrons who may remove them from the premises. Even worse, Article 28 (2) allows libraries and similar institutions to transmit the works they have digitized over networks, not only within their own premises, but also over interlibrary networks. Furthermore, a poviso in the 1999 draft amendments which forbade the use of such a transmitted copy

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list," mostly due to Korea's lack of full retroactive protection for pre-existing copyrighted works and problematic amendments to Korea's Copyright Act and CPPA. *See* USTR, Foreign Trade Barriers: Republic of Korea Trade Summary in 2000, 276, 285, *available at* http://www.ustr.gov/html/2001_korea.pdf.

108. *See* IIPA 2001 Report, *supra* note 102.

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. *See* USTR, *supra note* 106, at 286.

> outside the library . . . was dropped in the final text as enacted. These extraordinary exceptions for unauthorized digitization and networked distribution by libraries apply without regard to whether digitized copies or licenses for networked distribution, are available in the legitimate commercial marketplace. . . . With the expansion of the exception to cover interlibrary digital networks, an intolerable impact is highly likely. Such a sweeping exception cannot satisfy the well established international standards governing exceptions or limitations on protection, contained in Berne Article 9(2) and TRIPs [Agreement] Article 13.[114]

The above-noted concern is reflected in the situation faced by American book publishers. For example, in 2000, as a result of book piracy in Korean market, the U.S. publishing industry incurred an estimated loss of USD39 million, a fifty-six percent increase from 1995.[115] This loss represents the extent to which piracy practices are spread in small copy shops near college campuses, serving both professors and students alike.[116] However, the new legislation does not explicitly prohibit such practice.

Moreover, there are problems with regard to enforcement procedures and deterrent penalties in compliance with the TRIPs Agreement, namely, that: (1) damages as a "deterrent to further infringements" an inadequate (TRIPs Agreement Article 41.1); (2) in practice, judicial authorities do not order prompt and effective provisional measures, including *ex parte* measures (TRIPs Agreement Article 50); (3) there is a lack of transparency in tracking criminal prosecutions (TRIPs Agreement Articles 41.3 and 61); (4) the law enforcement community is reluctant to apply criminal penalties for copyright piracy on a commercial scale by refusing to treat software piracy as a "public offense" (TRIPs Agreement Article 61).[117]

Finally, as noted *supra*, in response to the rapid rise in computer software piracy, Korea enacted the Computer Program Protection Act ("CPPA") to extend copyright protection to computer software in 1989.[118] Nonetheless, Korea has been criti-

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114. *See* IIPA 2001 Report, *supra* note 102, at 221.
115. *See* USTR, *supra note* 106, at 286.
116. *Id.*
117. *See* IIPA 2001 Report, *supra* note 102, at 222, n 7.
118. *See* USTR, *supra* note 106.

cized for its deficient enforcement against end-user software piracy such as: (1) unfair treatment of certain types of software primarily produced by the U.S.; (2) lack of consultation with the computer industry concerning optimal targets for the inspections; and (3) sporadic enforcement of limited duration.[119]

The above illustrations confirm that, despite its efforts to strengthen copyright protection, Korea still suffers from international criticism on its lack of commitment to global copyright standards and vigorous enforcement against copyright infringement. However, without identifying and understanding the fundamental source of the above-noted problems, critique of Korean copyright law and enforcement would be counterproductive. Accordingly, the following section addresses the fundamental problems in enforcement of Korea's copyright law and suggested possible solutions.

B. Limits Arising from Differences in Legal System

1. Influence of Civil Law System in Korea: Limits in Damages

Korea's current legal system is modeled after civil law system of continental Europe which Korea adopted through Japan.[120] Accordingly, some have argued that "South Korea's civil law system lacks procedures characteristic of litigation practice in common law jurisdiction, such as discovery and the right to compel documents."[121] Further, Koreans' traditional reluctance to claim damages for their copyright violations is identical to the higher value attached to the criminal rather than civil sanction for libel in Korean society. Media law scholar Paeng Won-sun observed: "First, it has been a prevailing opinion in Korean society that a man who has injured another's reputation should be subject to penal punishment as part of retributive justice. Second, it has not been a tradition in Korea that infringement on the good name of another person ought to be compensated for in terms of monetary damages."[122]

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119. *See* IIPA 2001 Report, *supra* note 102, at 212–214.

120. Kyu Ho Youm, *Copyright Law in the Republic of Korea*, 17 UCLA PAC. BASIN L.J. 276, 299 (2000).

121. William Enger, *Korean Copyright Reform*, 7 UCLA PAC. BASIN L.J. 199, 207 (1990) (citation omitted).

122. WON-SUN PAENG, MAESU KOMYUNIKEISHYON POPCHEI IRON [A THEORY OF MASS COMMUNICATION LAW] 151 (rev. ed. 1988).

The Act indeed follows the continental model of emphasizing author's personal rights over their property rights, thus provides for damage awards and penal sanctions for violation of the author's moral right.[123] Article 95 of the Act provides that "[t]he author may demand a person who has infringed intentionally or negligently on his author's personal right to take measures necessary for the restoration of his reputation instead of or in addition to the compensation for damage."[124]

Sanctions for acts of copyright infringement are stipulated in Article 91 which provides that "[a]ny person who has the copyright or any other right protected under this Act . . . may demand of a person infringing his rights to suspend such act or demand a person likely to infringe his rights to take preventive measures or to deposit securities for compensation for damages."[125] Damages are estimated by profits gained by the infringement plus the amount which the complainant could have earned in excess of the defendant's profits.[126] When it is difficult to calculate the number of illegal publications, the law presumes 5,000 unauthorized book reprints and 10,000 unauthorized phonograph records.[127] Therefore, an author whose rights have been violated may seek injunction to stop the on-going violation and/or claim monetary damages.

The Copyright Act allows authors seeking civil damages against the violators to initiate criminal sanctions against these violators.[128] "By filing a criminal complaint . . . right holders can push prosecutors to take actions such as a raid and seizure of the infringing products. If the raid is successful and the infringer is convicted, the right holder can bring a civil action for damages, using the criminal conviction as evidence."[129] Further, criminal penalties can be used by authors as a partial cure for the pitfalls of civil remedies under the Copyright Act. Specifically, the Copyright Act provides criminal penalties for

123. *See* ETS, *supra* note 71, at 299.
124. Copyright Act of 2000, *supra* note 60, art 95.
125. *Id.* art. 91.
126. *Id.* art. 93.
127. *Id.* art. 94.
128. *See* Song & Kim, *supra* note 10, at 134.
129. *Id.*

"crime of infringement" of copyright [130] and "illegal publication."[131]

Criminal infringement of copyright includes: (1) infringement of the author's property rights protected by the Act by means of reproduction, public performance, broadcast, or public display; (2) infringement of moral rights that defames the dignity of the author; and (3) fraudulent copyright registration.[132] The 2000 Amendment of the Korean Copyright Act strengthens the penal provision for infringement of the author's property right by separating it under Article 97-5 from the Article 98 of the 1997 Act and increasing the maximum penalty penalty for infringement of authors' "property rights" to five years' imprisonment and 50 million won (USD40,000).[133] Article 98 makes a violation of the author's moral right a crime punishable by imprisonment of up to three years or a fine of not more than 30 million won (USD25,000).

Illegal publishing is defined as releasing: a work under a name or alias of a person other than that of the author; prejudicing the author's moral rights or defaming the dignity of a deceased author; operating a copyright agency business without obtaining a permit; knowingly importing goods that infringe on copyright or neighboring rights.[134] Article 99 makes acts of illegal publishing punishable by imprisonment of up to 1 year or a fine of not more than 10 million won (USD8,000).[135]

Nonetheless, unlike the U.S. criminal justice system, in which the prosecuting agency has the sole discretion in determining whether to prosecute certain defendants, regardless of the victims' wishes, the Korean legal system, with the exception of murder and other violent crimes, allows crime victims to initiate and drop charges against the violators.[136] This aspect of Korean legal system arguably undermines the deterrent effect of preventing the most serious copyright violators through criminal sanctions. In addition, compared with the penal provi-

130. Copyright Act of 2000, *supra* note 60, arts. 97-5, 98.
131. *Id.* art. 99.
132. *Id.* arts 97-5, 98.
133. *Compare* Copyright Act of 1997, *supra* note 51, art. 98 (1), *with* Copyright Act of 2000, *supra* note 60, art. 97-5.
134. Copyright Act of 2000, art. 99.
135. *Id.*
136. *See* Song & Kim, *supra* note 10, at 134.

sion of the copyright act of the U.S., which allows the copyright owner to receive the statutory fine up to USD150,000 from the violators,[137] the amount allowed under the 2000 amendment to the Korean Copyright Act is relatively minor.

2. Limited Enforcement Mechanisms

The main problem in Korea's copyright protection is the limited mechanisms for enforcing the Act. This problem mostly stems from cultural and educational limitations in the judiciary and government agencies that enforce the Act. For example, authors or owners of copyrights would have to make extraordinary efforts to enforce their rights against infringement in Korea because the Korean legal system requires direct complaints from copyright holders before the responsible governmental agencies can take any action against the alleged infringer.[138]

Further, the concept of damages is relatively new to the Korean legal system. As one commentator has noted:

> The amount of damages tends to be decided based on the profits earned by the infringer or the reasonable royalty, rather than the actual amount of loss to the right holder due to the infringement. Due to the lack of a pretrial discovery process, it is very difficult for the plaintiff to prove the infringer's profits. The courts, therefore, are inclined to rely on the reasonable royalty rather than the actual damages approach. The legal system of Korea is unfamiliar with the idea of treble damages or any kinds of punitive damages as a civil remedy. The lack of discovery, in combination with the lack of punitive damages, makes civil remedies an ineffective means of redressing an injury caused by infringement.[139]

He further notes:

> Providing effective civil remedies is not the only problem of intellectual property laws. It will require a review of the judicial system in Korea as a whole, including the court structure, legal education system, the process of selecting judges, and judicial administration to mention a few. The most significant

137. *See* 17 U.S.C. § 504.

138. *See* Suh, Eun Joo, *South Korea: Status of the Book Industry*, U.S. & Foreign Commercial Service and Dep't of State, *available at*, http://www.tradeport.org/ts/countries/skorea/isa/isar0028.html.

139. *See* Song & Kim, *supra* note 10, at 133.

> impact of TRIPs Agreement on Korea is that it urges the country to re-evaluate its entire system.[140]

The above suggestion is an ambitious one given the fact that the Korean legal community has been extremely reluctant to reform itself in the past.[141] Nonetheless, Korean courts seem to be slowly adopting the common law-based litigation and rights-based approach of the Anglo-American jurisprudence.

C. Sociocultural Influence: Absence of Copyright as a "Rights-based" Concept

Arguably, the most significant limit in the enforcement of copyright protection is deeply rooted in Korea's socio-cultural value system, which does not recognize the rights-based concept of copyright. Under the Confucian political philosophy, which deeply influenced the Korean value system, education was guided by the government and printing of books was a job of the government.[142] Reading books was not only a means of elevating social status by passing a national exam, but also an essential factor to become a "complete" human being.[143] While writers gained an honorable status through authorship, making money through writing books was not acceptable to an educated person.[144] Ideas or creative thoughts were considered to be in the public domain, not private property, and therefore copying a book written by others was not an offense, but instead a recommended activity, reflecting a passion for learning.[145]

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140. *Id.* at 134.

141. The Korean legal bar is notorious for maintaining status quo. For example, less than 2% of the total applicants for the Korean bar membership is admitted annually through extremely competitive examination process. Although younger generation of Korean lawyers has been advocating for increase of the bar membership, which became a pending bill in the Korean Assembly, this proposal was ultimately rejected. In addition, foreign attorneys are not allowed to practice in Korea. With the advent of global economy, however, it is possible that certain reforms may occur in Korea. For example, there is a bill pending in the Korean Assembly that would, though limited, allow foreign attorneys to practice in Korea. Japan recently passed a similar bill. *See* AsiaLaw Profile 2002: South Korea, *available at* http://www.asialaw.com/directories/asialaw2002/southkorea/default.htm.

142. *See* Song & Kim, *supra* note 10, at 120.

143. *Id.*

144. *Id.*

145. *Id.*

This long-standing traditional attitude toward intellectual property rights has not changed greatly, even after the enactment of intellectual property laws after World War II.[146] Accordingly, enacting Copyright Act is only the first step toward recognition of copyright. Without widespread understanding of the concept of copyright in society, enforcement of copyright cannot be accomplished merely by enacting a Copyright Act. The perception that intellectual property laws were enacted to meet the demands of foreigners, which is prevalent among average Koreans, only works against this requisite understanding of copyright.[147] Even law-enforcing institutions, including police, prosecutors and sometimes courts, are not free from such a negative attitude toward protection of copyright.[148]

D. Suggested Solutions

Korea's Copyright Act has arguably developed as a result of two main factors, namely, Korea's economic necessity to protect its own intellectual property rights and external pressures from western countries. However, these factors are not mutually exclusive. Considering Korea's economic development and its status as the second biggest Internet market in all of Asia,[149] it is not unimaginable that developing countries may infringe the Korean copyright in the near future. Therefore, it is inevitable for the Korean government to recognize that protection of copyright serves Korea's long term interests in economy and trade. President Kim Dae Jung recently expressed this recognition by stating that success of Korea's domestic software industry directly depends on a strong regime for the protection of intellectual property rights.[150]

It is certainly true that Korea has taken concrete steps to update its principal copyright law.[151] However, in the light of the rapid technological development occurring at unprecedented

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146. *Id.*
147. *Id.*
148. *See* Song & Kim, *supra* note 10, at 120.
149. *See* Int'l Communication Union, *Asia-Pacific Telecommunication Indicators 2002*, *available at* http://www.itu.int/osg/spu/spuactivities/2002/APTI2002.pdf.
150. *See* IIPA 2001 Report, *supra* note 107, at 287.
151. *See* IIPA, 2002 Special 301 Report; South Korea, 238 *available at* http://www.iipa.com/rbc/2002/ 2002SPEC301KOREA.pdf.

speeds, Korea needs to do more in modernizing its legal framework and reforming its enforcement practices to respond to the growing challenge of digital and online piracy.[152] Specifically, Korea needs to provide incentives for online service providers to cooperate in combating piracy. It may also clarify the copyright owner's rights in this field. This can be accomplished by transparency of enforcement against institutional end-user pirates, cooperation with the private sector, a sustained government's effort, and effective public education.[153] Most of all, the suggestions should be based on perception of the public and the government that piracy in this field will be the greatest impediment to the development of the Korean software and to Korea's goal of becoming a worldwide software power.[154] Accordingly, the ultimate solution to the copyright problem in Korea must derive from a positive perception of copyright protection and willingness on the part of the Korean government and its people to support it.

Yet, because the above-noted limits are essentially inherent within Korea's own socio-cultural and legal system, the Korean government's effort to effect the enforcement may be limited. Furthermore, the socio-cultural reluctance to recognize a rights-based concept of copyright may also limit the role of American and other western legal and political communities. International community may fill these gaps by providing educational support to various Korean institutions.

In short, the Korean society needs an acculturation process in becoming familiar with the values of copyright and the effect of its infringement. For example, international industry and non-profit organizations should increase their activities with the Korean counterparts in educating the Korean public about various copyright issues. In addition, countries with advanced copyright enforcement systems such as the U.S. should collaborate with the Korean government to provide enforcement training to Korean law enforcement officials, attorneys, prosecutors and members of judiciary. Finally, given that media plays a significant role in elevating public consciousness about certain social issues, utilizing the Korean media should be the primary

152. *Id.*
153. *Id.*
154. *Id.* at 240.

medium in educating the Korean public about copyright protection and the effect of its infringement.

In essence, the suggested approach reflects preventive and educational rather than reactive approach. While certain retaliatory mechanisms such as Section 301 and Super 301 have been effective in the short-run, given potentially devastating effects of such mechanisms,[155] it is doubtful that these mechanisms would continue to prove to be effective in the long-run. As discussed in this Note, the root of the problem in copyright protection in Korea is a cultural and educational one. Therefore, the ultimate solution to the copyright problem in Korea lies in educating the Korean public and society about the importance of copyright protection.

V. CONCLUSION

Mere accession to the multilateral treaties is not enough to meet the global trend to recognize the importance of copyright protection. Copyright piracy in books, video, music and business software programs will not disappear based on international criticisms alone. While the Korean government should set up a comprehensive system that would effectively enforce copyright violations and educate the Korean public about the importance of copyright protection, the international community should continue to collaborate with the Korean government to achieve those tasks.

Yunjeong Choi

155. Given the recent anti-American sentiment in Korea, retaliatory trade actions by the U.S. would further inflame such sentiment. *See* Jee-yeon Seo, *Anti-American Rallies Could Jeopardize US Investment*, KOREA TIMES, Jan. 10, 2003, *available at* http://times.hankooki.com/lpage/200301/kt2003011017383010160.htm.