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WASHINGTON UNIVERSITY  
UNIVERSITY COLLEGE  
DEPARTMENT OF ARTS AND SCIENCES

# Financial Crisis and Future Securities Regulation

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## A View from the Center

By

Mark E. Collins

A thesis presented to the Graduate School of Arts and Sciences of Washington University in partial fulfillment of the requirements for the degree of Masters of Arts

**September 2009**

**Saint Louis, Missouri**

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*“What improves the circumstances of the greater part can never be regarded as inconveniency to the whole. No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable.” Adam Smith, the Wealth of Nations*

The integration of the domestic financial markets into broader international markets will shape and determine the investment philosophies of companies and investors well into the future. It is more important than ever to recognize the significant roles countries play around the world in their relationship to each other. The focus has changed from an isolationist policy, to how to manage and constructively build efficiency and standardization internationally. This new focus has brought numerous opportunities for economic growth and prosperity to each country involved however attached to this opportunity is multiplied challenges not understood. The global community is currently and will further withstand systemic challenges to their respective markets and because of this; the current financial crisis merits our focus.

The walls that once separated our countries have been shattered and what were once referred to as domestic issues are now international problems. We must develop policies that will help to ensure stability, confidence and productivity into the domestic and international financial markets. A system of effective securities regulation, while adhering to a foundation of market incentives, will be the catalyst for increasing market efficiency and investment growth. For this reason I suggest that all new regulatory reform be constructed on the foundation of market efficiency and stability with a strict adherence to proactive due diligence.

It is essential that regulators and governments positions themselves strategically in creating a regulatory mechanism that will underscore this criterion. Regulatory actors in each country should be held responsible for helping to frame the new stages of regulatory reform and

should understand the complexities and direct impact these new policies will have on real people in various economies throughout the world. Domestic securities regulation should adhere to a strict code of bipartisanship and should not be focused on one set school of economic theory or political philosophy. Likewise, international securities regulation should be established around the principles of an international partnership of market efficiency that will pursue a strict adherence to a domestic regulatory framework.

This is quite idealistic to state, however if just Keynesian or Classical economic theory contained the answers, we would not have hundreds of opinions to say differently. It is essential to note that Adam Smith, John M. Keynes and Milton Freidman all have sound economic theories and principles however just one school of economics is not always the answer. This paper is written on the premise of driving a sense collaboration concerning the numerous theories of economics to find the optimal balance. The goal of this paper to lay the frame work for further scholarly debate, centered on a balanced and systematic strategy to frame policy, both domestically and internationally.

It is important to understand the reasons for the systemic problems that created and escalated the world directly into this financial crisis. The current financial crisis is not a general dichotomy between deregulation and regulation or between the housing bust and corporate giants too big to fail. According JP Morgan and their report entitled *Post Modern Asset Management*, the housing bust was simply the straw the broke the camel's back. JP Morgan states that U.S. home prices actually began to decline in 2006 which helped to set the stage for this crisis.<sup>1</sup> The report also alludes to the increased mobility of goods and capital on a globalized landscape

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<sup>1</sup> Institutional Asset Management Marketing Department. "Post-Modern Asset Management: The Credit Crisis and Beyond." JP Morgan Chase & Co. 2009 pg 8

which led to growth in emerging economies. This growth contributed to a sharp increase in excess global savings. Emerging countries such as China and India built large current-account surpluses and invested in low interest long-term rates in creditor-nation bonds.<sup>2</sup>

This created an abundance of cheap capital which consumers used to leverage for the purchase of real-estate and consumption. Through this abundance of capital and the enormous growth of real-estate leveraging, financial companies began to package these debt instruments in hopes of increased corporate revenues and equity returns.<sup>3</sup> This growth essentially caused a bubble in the market which led to speculation driving prices higher. According to Brian Perry's article entitled *An In-Depth Look at the Credit Crisis*, when enough investors come to realize that market or security valuations are not supported by fundamentals, the market will begin a downward spiral.

This essentially causes a multiplying effect of investors rushing to sell the underlying securities or get out of the market completely.<sup>4</sup> Perry also discusses what he has perceived as two other factors that have helped create the crisis we have today. The moral hazard problem is the excessive leveraging and risk taken by both financial corporations and the individual consumers. However the second is what is known as asset/liability mismatch. Asset/liability mismatch is when a financial corporation has a broad discrepancy between the duration of its assets and its liabilities.

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<sup>2</sup> Institutional Asset Management Marketing Department. "Post-Modern Asset Management: The Credit Crisis and Beyond." JP Morgan Chase & Co. 2009 pg 8.

<sup>3</sup> Institutional Asset Management Marketing Department. "Post-Modern Asset Management: The Credit Crisis and Beyond." JP Morgan Chase & Co. 2009 pg 9

<sup>4</sup> Perry, Brian. "An In-Depth Look at the Credit Crisis." Investopedia a Forbes Digital Company. (2008): 6 <<http://www.investopedia.com/university/credit-crisis/>>.

An example of this is when commercial banks found it difficult to find short-term financing during a period of severe illiquidity. This is a serious problem in that banks rely heavily on this type of financing to conduct day to day business. This was the main reason why investment banks such as Morgan Stanley and Goldman Sachs became bank holding companies.<sup>5</sup> The problem exists when financial institutions employ excessive leveraging. According to Perry, commercial banks traditionally leverage 10 to 12 times their capital whereas investment banks were in excess of 30 times capital. This is a tremendous increase in disproportionate risk to the institution as well as the individual investor.

Table 1 and 2, illustrates the increase in leveraging that has taken place in the U.S. since 1964. Table 1 shows the total amount of domestic financial debt represented at \$16.9 trillion while table 2 illustrates total debt including the government sector at 2.5 trillion. It is important to note that table 2 represents Debt/GDP. If the line shown is rising, than debt is increasing faster than the growth of GDP. Depending who you talk to, debt is or can be major challenge to overall health of a country or to the international financial system. The difficulty lies in determining the right balance or mix of debt that helps to sustain an economy of scale.

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<sup>5</sup> Perry, Brian. "An In-Depth Look at the Credit Crisis," Investopedia a Forbes Digital Company.(2008):8 <<http://www.investopedia.com/university/credit-crisis/>>.



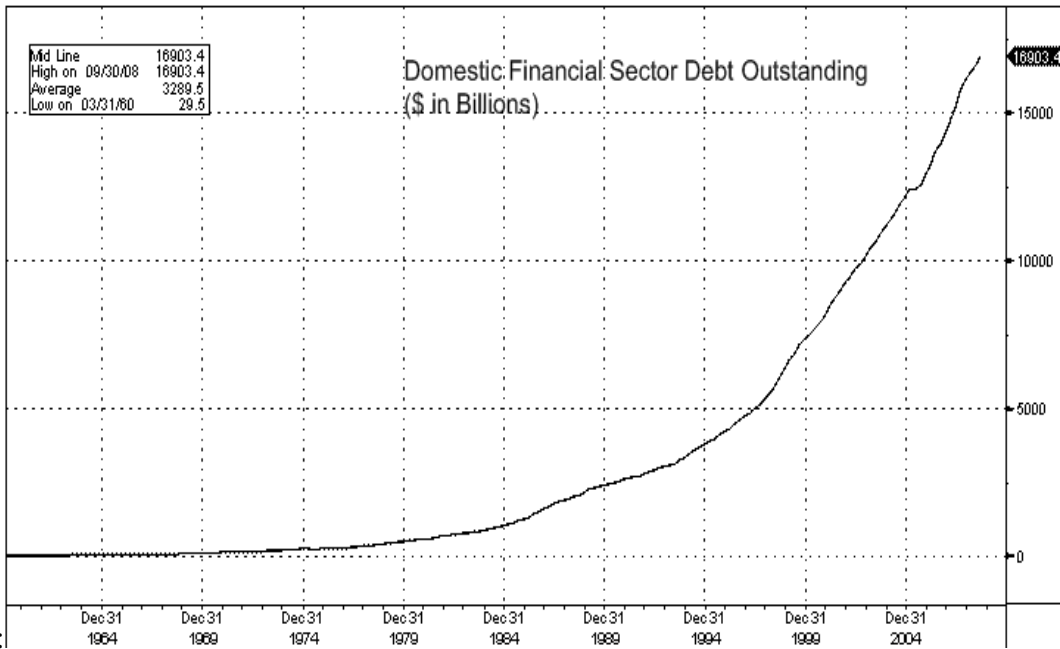


Table 1:

Source: ContraHour U.S. Domestic Debt: What Can Be Expanded, What Must Be Reduced?" <<http://seekingalpha.com/article/116929-u-s-domestic-debt-what-can-be-expanded-what-must-be-reduced>>, 2009

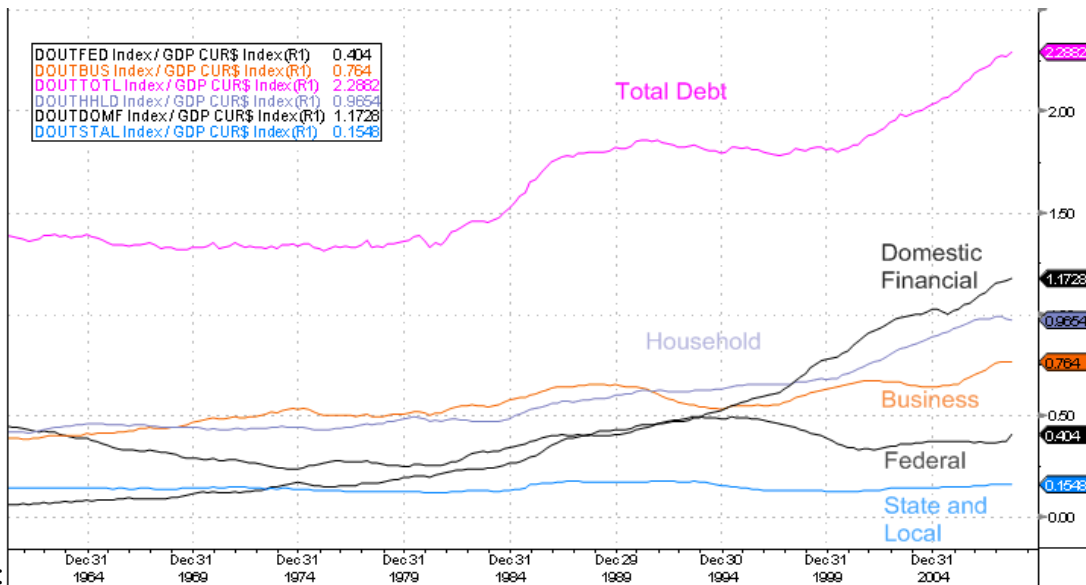


Table 2:

Source: ContraHour U.S. Domestic Debt: What Can Be Expanded, What Must Be Reduced?" <<http://seekingalpha.com/article/116929-u-s-domestic-debt-what-can-be-expanded-what-must-be-reduced>> 2009.

However one of the most important factors to understand the systemic challenges this crisis has produced is to recognize the underlying reason that some of these actions took place. According to Professor Bill George at Harvard University's School of Business, it is the notion of the lack of trust in our nation's leaders. For example the Center of Public Leadership at Harvard's Kennedy School of Government, revealed an astounding 80 percent of American people believe we have a severe leadership crisis in the this country. The report also states that an unprecedented 79 percent believe the United States will decline as a nation if we do not get better leadership.<sup>6</sup> This report took into account both corporate leaders and elected officials.

It is important to note that confidence in leadership has a direct effect on market participation and economic stability. These problems will rest on the shoulders of those who lead us. The credit crisis will depend essentially how long it takes the credit markets to be liquid again.<sup>7</sup> If banks are unwilling to lend to each other out of fear of the other banks stability then this credit crisis will last much longer. The actions of Henry Paulson, Timothy Geithner and Ben Bernanke in taking the approach to bring economic stability through monetary policy are essential to not only to the United States but also the international community.

The failure of government actions to regulate the financial markets, corporate greed and the housing bust all contributed to this crisis and to what some are calling the perfect storm. Problems such as these have helped to create the financial crisis and unattended to will further establish an unprecedented challenge for future generations. This further highlights the argument for an in-depth strategy of forecasts to develop the correct balance of regulatory action

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<sup>6</sup> George, Bill, "Failed Leadership Caused the Financial Crisis." US News & World Report. 19 Nov.2008. <<http://www.usnews.com/articles/opinion/2008/11/19/failed-leadership-caused-the-financial-crisis.html>>.

<sup>7</sup> Thayer, Gary, Economic Comment Historic Changes, Wells Fargo Economic Group, 1 Oct. 2008.

and market efficiency. Forecasts or expectations of future variables are considered rational if the econometrician uses all relevant information that is available during the process of policy creation or reform.<sup>8</sup> Information is a limited resource and regulatory reform will have certain political and time constraints.

Politicians and economist do not have the luxury of unlimited time and information when reacting to a crisis. Therefore it is crucial that the reforms created must be revisited constantly. As a result, there should be an attempt to revise the way governments forecast in order to predict probable systematic errors.<sup>9</sup> The financial crisis has initiated great concern with the current mechanism of securities regulation and its failed attempts to govern the immense and complex investment options available. Wall Street pioneers admit that some of the complex derivatives and collateralized mortgage debentures are too difficult to understand let alone regulate.

Theories and the descriptions of current regulation presented in this paper will help the reader gain a basic understanding of the general driving force of financial policies and more importantly, securities regulation. There is currently an immense capitalization of new theories of domestic and international securities regulation. The global financial crisis of 2008 will continue to cause systemic challenges that will unfold for years to come. Already we are seeing inflationary worries and protectionist philosophies on an international basis. Individual investors and corporate executives all around the world are all concerned that our current regulatory bodies are not equipped to aide in protecting the markets from fraudulent activity.

Consequently in late 2008 early 2009, the Dow Jones Industrial Average (referred to as the Dow) went from 13,000 to 7,500, almost overnight. The markets, being the leading predictor, that they are,

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<sup>8</sup> Baumol and Blinder. Economics Principles and Policy. Harcourt College Publishers 8<sup>th</sup> ed. P.718.

<sup>9</sup> Eatwell, Milgate and Newman. The New Palgrave Dictionary of Economics. 4 Q to Z. Macmillan Press Limited. 1987 P.79.

showed us we were headed to a severe recession if not a widespread depression domestically and internationally. Some investors saw their respective retirement accounts lose 30 to 40 percent while others were left with absolutely nothing. For this reason a number of people chose to sell their personal investments and hide in fixed income vehicles or liquid cash accounts. The US government knew it had to act and act quickly, however because of the typical partisan challenges, initial progress was delayed.

Today we have laid the ground work for a new economy to emerge. With only a handful of domestic and international large commercial banks remaining, the world as we knew it is over and the start of something new has began. The Securities and Exchange Commission along with Secretary Timothy Geithner, Chairman Ben Bernanke and Chairman Mary Schapiro will help to reform America's current securities regulation and monetary policy. President Obama and the U.S. Congress will ultimately try and sell these regulations to America and the rest of the world. The current administration will develop new legislation and regulation and try to implement it in a very short time. These new regulations will have an undetermined impact on both individual investors and the global economy in general.

It is the responsibility of governments and regulatory actors around the world to create a standardized frame work of regulation that is formed around incentives and efficiencies of economic growth and stability. Organizations such as the International Monetary Fund, Securities Exchange Commission and the International Organization of Securities Commission will need to act in accordance to these regulations and work together to rid the markets of unneeded confusion and fraudulent activity. Regulatory objectives must be to create a mechanism that will provide protection and transparency for the investor, while at the same time to facilitate investment growth, progress and stability.

As a result, this paper will focus on three important aspects of regulation. The first section will concentrate on the historical perspective -- where we were. From the historical perspective I will discuss the establishment and role of the Securities and Exchange Commission and how they came about. I will

also describe some of the important regulations that have helped to establish our current securities markets. The second section will be written around the purpose of securities regulation- -where we are.

Most everyone is trigger happy when discussing more widespread regulation. In general, economists feel that there is a legitimate need for increased regulatory reform and greater disclosure. However there should be an unambiguous reason for reform so we gain a solid and clear perspective of its purpose and effect. The third section will concentrate on a normative approach to -- where we are going. We will focus on a 'Glass-Steagall Act' type of reform concerning retirement and the balance of full disclosure. This article was written on the level to provide possible normative solutions and to spur further scholarly research in the field of securities regulation.

*“There is with general willingness now to question existing regulatory practices and to consider, without prejudice, a wide range of alternative proposals. Nothing at this juncture is too hallowed by tradition and usage to escape questioning and to be off-limits to reform.”*

*(Geneva Reports on the World Economy)*

### ***Section 1: Understanding Where We Were***

At this point I will begin to discuss the history of regulation, the purpose of regulation and recommendations for and what types of regulations may be necessary in our near future. The regulatory constructs of both domestic and foreign governments will help to rebuild confidence in the domestic and international financial systems. The current problems we face are unprecedented and complex in nature. The once held strong multinational corporations were no match for today’s challenges and complex economies. Essentially in this current day and age, the global community has never been this tightly networked and dependent on each society to fulfill their responsibilities for the global circulation of goods and services.

From the everyday investor to Wall Street pioneers it seems that everyone feels the era of deregulation is over and it is now time for the creation and implementation of new and improved regulatory constructs. Most professional, academic and civil servant sectors also believe that new regulatory reforms are needed. Investors among every class have begun to internalize massive losses in wealth and are looking for an immediate response from our regulators and politicians. The complex investment vehicle rampant among our markets and the current system of lax regulation has and will continue to cause immense challenges throughout domestic and international financial systems. Consequently, we need a general

understanding of where we have come from in order to gain a clear perception of future normative evaluations and forecasts surrounding securities regulation.

### *1.1 Regulation and the Securities and Exchange Commission*

During the 1930's, the financial securities markets saw regulatory guidelines increase in measure and in scope. The financial crisis was the catalyst necessary for new regulatory bodies and mechanisms to emerge in America during the Great Depression. The U.S. Congress established the Securities Act of 1933 also known as the "Truth in Securities Act", as one of the first attempts of securities regulation after the stock market crash of October 29, 1929.<sup>10</sup> The purpose of the Securities Act of 1933 was to prohibit numerous forms of fraud and to bring stability to the securities industry by requiring that all essential information concerning the issuance of securities be made available to the investor.<sup>11</sup>

The Securities Act of 1933 provides the definition of a security and what the legal ramifications are that covers the selling and issuance of securities. According to the Act of '33, two prevailing factors should be noted concerning securities. First, the act requires that the investing public is to receive financial and other essential information concerning the security that is being offered. Second, the Act should help to facilitate a system to prohibit all types of fraud, deceit, and misrepresentation concerning the sale of securities to the public.<sup>12</sup>

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<sup>10</sup> Norris, Floyd. "Looking Back at the Crash of '29." New York Times 15 Oct. 1999, <<http://www.nytimes.com/library/financial/index-1929-crash.html>>.

<sup>11</sup> Clarkson, Miller, Jentz and Cross. West's Business Law 8<sup>th</sup> ed. United States: West Legal Studies in Business Thompson Learning, 2001. Pg 691.

<sup>12</sup>"The Securities and Exchange Commission." The Laws that Govern the Securities Industry. <<http://www.sec.gov/about/laws.shtml>> See 15 U.S.C> Section 77b(a)(1).

The Act stipulates that the means to accomplish these goals include creating a mechanism to foster the registration of securities. According to the Securities and Exchange Commission, the information provided by the company issuing the security will help to facilitate important information to investors making an informed conclusion as to what securities to purchase.<sup>13</sup> In general all securities must be registered with the SEC prior to being sold in the United States. Companies must provide information as to the description of the type of business the firm conducts and any properties the firm holds or manages. As well as a description of the securities to be offered for sale and any other information that is important to note. There must also be a description of firm management and the financial statements must be certified by an independent accountant.<sup>14</sup>

## *1.2 Disclosure*

Essentially the Act of '33 lists an all encompassing system of regulation surrounding the issuance of securities and the requirement of disclosing essential information to the investor. Disclosure is the most discussed form of regulation today. Technological advances, such as the Internet and television, have increased disclosure by firms immensely. Both internet and the television have greatly influenced the facilitation and dissemination of information.<sup>15</sup> The disclosure of essential information has also increased through Regulation S-K. Regulation S-K

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<sup>13</sup> "The Securities and Exchange Commission." The Laws that Govern the Securities Industry. <<http://www.sec.gov/about/laws.shtml>> See 15 U.S.C>.

<sup>14</sup>"The Securities and Exchange Commission." The Laws that Govern the Securities Industry. <<http://www.sec.gov/about/laws.shtml>> Section 77 b(a)(1). Primary means of accomplishing these goals is the disclosure of important financial information through process of securities regulation. This information enables investors to make informed judgments about whether to purchase a company's securities. While the SEC requires that the information provided be accurate, it does not guarantee it.

<sup>15</sup> Garcia, Tonya PR Week USA Aug 01, 2007 The Internets role in Financial Disclosure Debated <<http://www.brandrepublic.com/InDepth/Analysis/674732/Internets-role-financial-disclosure-debated/?DCMP=ILC-BETASEARCH>>.



provides a mechanism of disclosure for essential information with respect to such matters as a firm registrant's business model, legal proceedings, properties, financial and non-financial statements, directors and officers.<sup>16</sup> One important part of Regulation S-K is the Management's Discussion and Analysis.

Essentially, MD&A requires the reporting firm to disclose critical data outlined in regulatory guidelines and instructions. MD&A requires the firm to disclose its financial condition, current operations, liquidity, and capital resources. One other important factor to note is that if the registrant of regulation S-K has concerns with the firm, then they may require further disclosure.<sup>17</sup> Fundamentally, a major purpose of the registrant is to gain as much information as possible of the underlying firm, not only for purpose of registration but also for the transparency of the security.

### *1.3 Securities and Exchange Commission*

After one year of the most sweeping regulatory reform the world has seen yet, a new group of guidelines emerged, the Securities and Exchange Act of 1934. This act created the SEC and further enhanced securities regulation. The SEC was established as an independent regulatory agency, the sole function of which is to administer the Securities Act of 1933.<sup>18</sup> Today the SEC plays an important role in the creation and implementations of regulations

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<sup>16</sup> "The Securities and Exchange Commission." Regulation S-K: C.F.R. 299.10-229.702. 23 July 2009 <<http://www.sec.gov/divisions/corpfin/ecfrlinks.shtml>>.

<sup>17</sup> Paredes, Troy. Blinded by the Light: Information Overload and its Consequences for Securities Regulation. Faculty Working Papers Series Washington University School of Law, Saint Louis: 2003. 03-02-02.

<sup>18</sup> "Sec Historical." 431 Days: Joseph P. Kennedy and the Creation of the SEC. 1 Dec. 2005, <<http://www.sechistorical.org/museum/galleries/kennedy/index.php>>.

governing the issuance and sale of securities.<sup>19</sup> The SEC regulates the securities industry by using numerous mechanisms and systemic practices.

For starters, the SEC requires full disclosure of what regulators like to call complete information, concerning the offering of securities. They govern new securities listed on the primary market as well as the securities being sold on secondary market such as the Over the Counter exchange, better known as the OTC exchange.<sup>20</sup> The SEC investigates fraudulent activity and requires registration of securities brokers, broker dealers, and investment advisors. They also will recommend administrative sanctions, injunctive procedures, and criminal prosecution in cases involving violation of securities laws.<sup>21</sup> This act was also responsible for the creation of various self-regulatory organizations (SRO's).

#### *1.4 The Creation of Self Regulatory Organizations*

The SEC delegate's authority to the National Associations of Securities Dealers or what is known today as Financial Industry Regulatory Authority (FINRA), to aid in the prevention of investment fraud and public awareness of topics surrounding the securities markets. Organization such as the New York Stock Exchange, American Stock Exchange and the Pacific Stock Exchange were also created through the Act of 1934. One of the goals of a stock exchange is to maximize trading volume and trading efficiency. Basically the more trading

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<sup>19</sup> Clark, Miller, Jentz, and Cross. "Corporations-Securities Regulation and Investor Protection." West's Business Law United States: Thomson Learning, 2001.

<sup>20</sup> "The Securities and Exchange Commission." The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation. <<http://www.sec.gov/about/whatwedo.shtml>>.

<sup>21</sup> Clark, Miller, Jentz, and Cross. "Corporations-Securities Regulation and Investor Protection." West's Business Law United States: Thomson Learning, 2001.

volume the exchange has the more the exchange maximizes their potential at increasing revenues.

SOR's have for a number of years created and implemented governing aspects in the exchanges even before formal regulatory and legislative action was created.<sup>22</sup> This interesting phenomenon occurred both in the United States and United Kingdom securities exchanges. Consequently, the exchanges became a type of regulatory body by enforcing policy and procedures concerning the buying and selling of securities. The exchanges enforced policy agendas of fair and competitive market actions on the market makers, broker dealers and the investors.<sup>23</sup>

There are of course numerous views concerning regulatory oversight or the securities market. The Classical economist would argue that allowing exchanges to govern the actions of securities market as an example of free-markets and highlight their ongoing concern of government involvement. They would stipulate this is all the more reason for governments to stay out of the markets and to let the markets regulate themselves through competition. Consequently, there are numerous challenges with this position. There are three main reasons why the Classical view will not work as efficiently as considered necessary.

First, SRO's do not have the ability to inflict punitive damages on those that break the rules of the organization compared to the reach of the state or federal government. Second, the type of action necessary would be costly and challenging for an SRO to continue on a consistent

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<sup>22</sup> Coffee, John. The Rise of Dispersed Ownership: The Role of Law and the State in the Separation of Ownership and Control, Columbia University School of Law. New York: 2000. Working Paper No182.

<sup>23</sup> Coffee, *supra* note [22], ("the London Stock Exchange changed their rules and guidelines to tighten and require issuers to reveal all important information.").

basis. Third, if previous points hold true the SRO has a weak incentive to enforce rules against its own members and clients.<sup>24</sup> Consequently these views highlight the need for further regulatory measures especially those concerned with fraudulent activities and unfair practices.

### *1.5 Rule 10b-5 Insider Trading*

The Act of 1934, Section 10(b) rule 10b-5 is essential to note. The rule in general states that it prohibits the use of any manipulative practices that are in direct conflict with SEC rules and regulations. It prohibits fraudulent activities in connection with the purchase, sale or issuance of securities.<sup>25</sup> This is known as one of the most important purposes of Rule 10b-5 relates to insider trading. The rule is focused around those investors that have access to privileged information that the general public does not have access to.

As a result, the insider trading rule strictly prohibits officers and executives that have privileged positions in a publically traded company, from trading on information until the information becomes available to the public.<sup>26</sup> In the 1980's no better description of insider trading is the movie "Wall Street", directed by Olive Stone. The movie was created to depict insider trading and the "greed is good" philosophy. While this movie may have been eluding to

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<sup>24</sup> Coffee, *supra* note [22] Showing an explanation of three reasons that Professor Coffee believes are why completion and free-market framework will not be able to stand alone.

<sup>25</sup> "Title 17: Commodity and Securities Exchange, Part 240 General Rules and Regulations Securities Exchange Act of 1934." GPO Access. <<http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr;sid=c9e95480522af21cb401afc0a81e0cb5;rgn=div5;view=text;node=17%3A3.0.1.1.1;idno=17;cc=ecfr#17:3.0.1.1.1.57.72>>. (It shall be unlawful for any persons, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange. (a) To employ any device, scheme, or artifice to defraud. (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in- any course of business which operates or would operate as a fraud or deceit upon any persons, in connection with a security.)

<sup>26</sup>Clark, Miller, Jentz, and Cross. "Corporations-Securities Regulation and Investor Protection." West's Business Law United States: Thomson Learning, 2001.

this type of activity in the 1980's, insider trading existed well before the Great Depression. Originally, insider trading was a restriction in the Act of 1934 under Section 16, however today the regulation is listed under Rule 10b-5.<sup>27</sup>

In 1961, the rule 10b-5 applied to insider trading. In the 1980's the Supreme Court adopted insider trading and the rule was framed under a fraudulent activity.<sup>28</sup> Basically the government was announcing that they no longer believed that insider trading was an externality or a market failure that the private markets could control. They believed that this type of practice was essentially an externality that was caused by fraudulent activity. That regulation should be in place to stop and to enforce some type of punitive consequences on those caught in the act. There are numerous theories for and against insider trading however I will focus on the activity of political actions and actors.

### *1.6 Political Economy View of Insider Trading*

The political economy perspective must highlight the public interest theory of regulation. Essentially, the public interest theory of regulation stipulates that governments act in accordance to correct market failures.<sup>29</sup> Insider trading regulation through government involvement would be an example of public interest theory. Essentially, regulatory actors see insider trading as a

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<sup>27</sup> "Ownership Reports and Trading by Officers, Directors and Principals." Securities and Exchange Commission. <<http://www.sec.gov/rules/final/34-46421.htm>>. Aug 2002. See: *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

<sup>28</sup> Garrett, Ray Jr. "An inside look at Rule 10b-5." Securities and Exchange Commission. <<http://www.sec.gov/news/speech/1975/041075garrett.pdf>>. April 1975. See: *Chiarella v. United States*, 445 U.S. 222 (1980).

<sup>29</sup> Posner, Richard. Theories of Economic Regulation, Working Paper. University of Chicago School of Law, Chicago: 1974. W0041. (Reviewing theories of regulation, including public interest theory, Public Enforcement of Securities Laws).

market failure and they feel that they must step in because the private markets are not equipped and lack the incentive to solve these types' challenges.

According to Professor Stigler, there are two main types of market failures, monopolies and externalities. Professor Stigler believes that regulation is critical for the public to be protected during these types of events.<sup>30</sup> Although monopolies' are an essential argument for the creation and implementation of regulation I am not going to emphasize this theory. Instead, I am going to focus on externalities. According to Stigler, externalities are basically activated when the cost of producing a good or service are not fully integrated into the pricing mechanism. So essentially the investor does not have the information required to make a sound decision and has a greater chance of losing their initial investments to externalities.

In effect, regulation is a social welfare mechanism presented to decrease the externalities that hinder markets and cause failures. A major question and consistent argument concerning regulation is where did the regulatory guideline begin and who is behind the creation and implementation of that regulation? Those that oppose the regulation rely on public interest theory, to explain that most laws are created under special interest or private interest.<sup>31</sup> Consequently, those who support regulation are generally those that rely also on public interest theory and explain the law to be fashioned around the issue of externalities and market failures.

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<sup>30</sup> Stigler, George J. 1971. "Theory of Economic Regulation." *Bell Journal of Economics and Management Science* 2 (Spring): 3-21.

Peltzman, S. 1976. "Toward a More General Theory of Regulation." *Journal of Law and Economics* 19 (August): 211-40.

Becker, G.S. 1983. "A Theory of Competition Among Pressure Groups for Political Influence." *Quarterly Journal of Economics* 98 (August): 371-400.

"Public Interest Theory and Market Failure." [Texas Politics Theories of Economic Regulation.](http://www.laits.utexas.edu/txp_media/html/bur/features/0403_02/slide1.html)  
<[http://www.laits.utexas.edu/txp\\_media/html/bur/features/0403\\_02/slide1.html](http://www.laits.utexas.edu/txp_media/html/bur/features/0403_02/slide1.html)>.

<sup>31</sup> Haddock & Macey. [Regulation on Demand](http://www.jstor.org/pss/725499), *Journal of Law and Economics* Vol. 20 No.2. Chicago: Oct. 1987.  
<<http://www.jstor.org/pss/725499>>.

<sup>32</sup> Regardless, regulatory guidelines have been created and implemented for the purposes of decreasing market failures and increasing market participation.

### *1.7 Trust Indenture Act of 1939*

There are basically two types of investments, the purchase of equities (common or preferred stock) and the purchase of debt securities (bonds or treasuries). Both are equally important and can be a source of income or capital growth to the individual or institutional investor. Typically investors will use both vehicles to build a portfolio that is centered on their prospective goals and investment objectives. The Trust Indenture Act of 1939 deals with debt securities. Even though the security in question may have already been registered under the Securities Act of 1933, there may not be a formal agreement between the issuer and holder of the debt security.

Essentially a corporation that is issuing more than 10 million in debt must provide an indenture between the issuer and the trustee that will act on behalf of the bondholder.<sup>33</sup> The trustee is usually a bank or a trust consisting of board members, which will act in the bondholders' interest not the issuer of the security. The terms and conditions of the bond must be spelled out in detail in the indenture.<sup>34</sup> It is generally thought that investment companies, such as broker dealers, financial services companies and/or mutual funds are created for the buying, selling and research of certain investments. This area is often overlooked concerning securities regulations.

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<sup>32</sup> James D. Cox, *Insider Trading and Contracting: A Critical Response to the Chicago School*, Duke Law Journal. Vol. 1986 No. 4 Durham NC: Sept. 1986. <<http://www.jstor.org/pss/1372486>>.

<sup>33</sup> "Securities and Exchange Commission." Trust Indenture Act of 1939. 2004 Sept. <<http://www.sec.gov/about/laws/tia39.pdf>>.

<sup>34</sup> "Title 15 Commerce and Trade." Securities and Trust Indentures. 2008 Jan. <<http://uscode.house.gov/download/pls/15C2A.txt>>.

## *1.8 The Act's of 1940*

It is universally held that the general public commonly does not have much trepidation concerning investment companies. Nor does the public feel that these companies harbor any activity that will cause or create fraudulent actions. However with the recent fall of some of the largest institution in history, there is now a renewed interest in regulation covering investment companies. Numerous hedge funds, banks, and broker dealers have aided in the creation of fraud, ponzi schemes and poor investment decisions. This is where the Investment Company Act of 1940 exacts authority.

Essentially, the Act requires the registration and regulation of investment companies. The purpose is to effectively reduce abuses in selling securities and to help assure investors of adequate and complete information. The Act requires that all investment companies register with the SEC and adhere to the rules and regulations that have already been established through prior actions taken by Congress and the SEC.<sup>35</sup> One micro-level policy that is clearly seen as an important regulation to the investing public is the Investment Advisors Act of 1940.

This Act created an enforcement mechanism which established policy and procedure that investment advisors must be registered and adheres to regulations administered by the SEC.<sup>36</sup> In general the investment advisor is a person who provides recommendation concerning a specific security. The Act of 1940 aides in providing registration concerning the advisor essentially

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<sup>35</sup> "United States House of Representatives." USC Investment Companies and Advisers. 1 Jan 2008. <<http://uscode.house.gov/download/pls/15C2D.txt>>.

<sup>36</sup>"Securities and Exchange Commission." Investment Advisors Act of 1940. 10 Aug 1998. <<http://www.sec.gov/rules/extra/ia1940.htm>>.



because they provide recommendations to their clients; and receive compensation for these services.<sup>37</sup> However there are some that are excluded from registration requirements of the Act.

For example banks, bank holding companies, or providers of advice that is incidental to their profession. These providers could be but are not limited to lawyers, accountants, engineers and teachers. They are exempt as long as they do not hold themselves as advisor to the public, they do not charge a fee for their services and the advice they give is under reasonable terms related to their occupation.<sup>38</sup>

Some individual investors have consistently had less confidence in their investment advisors ability to give unbiased and professional advice without hidden agendas. Essentially every advisor has an opinion on what they have interpreted as being a quality sound investment. You can take ten advisors and they will give you ten different opinions concerning the same security under question. The industry has made strides in trying to create a sense of confidence, structure and consistency in the advisors by introducing new and improved product lines, such as managed or advisory products.

The advisor acknowledges that they can give aggregated investment advice concerning where to invest and how to invest, but leaves the actual management of money in the professional managers hands. These types of accounts however have an interesting performance metrics. Essentially the advisor and the investor contractually agree to a certain fee for the management of the entire account. The advisors compensation is tied directly to the

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<sup>37</sup> "United States House of Representatives." USC Investment Companies and Advisers. 1 Jan 2008. <<http://uscode.house.gov/download/pls/15C2D.txt>>.

<sup>38</sup> "Securities and Exchange Commission." Investment Advisors Act of 1940. 10 Aug 1998. <<http://www.sec.gov/rules/extra/ia1940.htm>>.

performance of the account. Essentially if the account performs positively or negatively, the advisor is only going to get the contractually agreed upon rate. Therefore it is an incentive for the account to perform positively for the given year.

### *1.9 Sarbanes Oxley Act of 2002*

The mid to late 1990's and early 2000's were plagued by fragile corporations and the questionable accounting practices that surrounded them. Many corporations were inducing what they referred to as creative accounting measures.<sup>39</sup> This made it almost impossible for the general public to really know what they were investing in. Most general investors will invest into whatever company their investment advisor recommends for them or what the research report is declaring. However if the advisor or research company is making their respective recommendations based off incorrect accounting information, the investor will be making their decision from untruthful and incomplete information.

This is a violation of the Securities Act of 1933. Hence former President George W. Bush signed the Sarbanes-Oxley Act of 2002 into law. The law created a number of reforms to improve corporate responsibility in the creation of financial disclosure and to aid in prohibiting accounting fraud. The Act also created the Public Company Accounting Oversight Board, (PCAOB) to oversee the auditing profession.<sup>40</sup> Sarbanes-Oxley, of course had its fair share of challenges with the private sector. Firms argued essentially that this requirement would decrease

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<sup>39</sup> Lomax, Stan. "Moore School of Business University of South Carolina." Cooking the Books. <<http://mooreschool.sc.edu/moore/research/Publications/BandE/bande49/49n3/cooking.html>>.

<sup>40</sup> "Securities and Exchange Commission." The Laws That Govern the Securities Industry. 26 Aug 2008. <<http://www.sec.gov/about/laws.shtml>>.

business efficiency and production; however, the regulation has been proven useful in the last few years.

### *1.10 International Securities Regulation*

There are numerous agencies and regulatory bodies throughout the international world. All major countries adhere to some degree of regulatory constructs. Regulatory systems have been created and implemented on a domestic scale; however, international regulation centers itself on financial and economic mechanisms, underlying macro-level constructs. Consequently international securities regulations are very similar to the domestic versions that were already outlined. Therefore we are focusing on disclosure which seems to be the driving force behind the creation of domestic and international regulation.

One important organization to note is the International Organization of Securities Commission. Essentially, the IOSCO is an organization that has helped to create and maintain numerous financial and securities regulations by bringing together countries around the world to focus on disclosure. The IOSCO was founded in 1974 as the Inter-American Conference of Securities Commission and they currently have 182 members. This organization is the foremost important organization concerning international securities regulation however they currently are not equipped with an effective enforcement mechanism.<sup>41</sup>

The IOSCO is very concerned with full disclosure on an international scale. With the release of the documents entitled, *Disclosure Standards for Cross-Border Offering and Initial Listings by Foreign Issuers* and the *International Disclosure Principles of Cross-Border*

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<sup>41</sup> "Inter-American Conference of Securities Commission." IOSCO Historical Background. 2009. <<http://www.iosco.org/about/index.cfm?section=history>>.

*Offerings and Listings of Debt Securities by Foreign Issuers*, the organization plans to take the issue head on. Through these documents and other actions the IOSCO helped to create an enhancement to the disclosure of information offered by multinational issuers of securities.<sup>42</sup> Through these actions, regulators hope to add more integrity in the financial markets which will in turn help to create investor protection on an international scale.

Organizations such as the World Bank and International Finance Corporation, seek to find solutions in the private sector to increase economic development through investments in emerging countries. Basically these organizations help to establish systems and solutions for the flow of currencies, loan instruments and the movement of trade between countries. However the European Union has created and delivered a wide range of incentives concerning regulation among its 27 member countries. The Financial Stability Forum (FSF), in the EU has been given responsibility of converging international financial regulation.<sup>43</sup> FSF will work closely with the IMF on the macro-economic level however, for the first time the EU will introduce a micro-economic approach to systemic financial and securities regulation.<sup>44</sup> The EU will do this by creating policy and procedural guidelines for financial firms and security transactions.

This section outlined the historical perspective of where we have come from. One can see that regulatory constructs have been around for quite some time. It seems that there is a

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<sup>42</sup> "International Disclosure Principles for Cross-Border Offerings and Listings for Debt Securities by Foreign Issuers." IOSCO Final Draft Technical Committee. 2007.  
<<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD242.pdf>>

<sup>43</sup> "European Union." Brief Summary of the De Larosiere Report.  
<[http://ec.europa.eu/commission\\_barroso/president/pdf/statement\\_20090225.pdf](http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225.pdf)>.

<sup>44</sup> "European Union." Communication From the Commission to the European Council. 29 Oct 2008.  
<[http://ec.europa.eu/commission\\_barroso/president/pdf/statement\\_20090225.pdf](http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225.pdf)> See also:  
<[http://ec.europa.eu/commission\\_barroso/president/pdf/Comm\\_20081126.pdf](http://ec.europa.eu/commission_barroso/president/pdf/Comm_20081126.pdf)>.

common thread throughout this section, that crisis seems to be the catalyst for regulatory reform. It is easier to construct and reform regulation when we are going through a market failure however it is much more of a challenge to consistently modify our markets and systems. Being reactive only produces inefficiency. Being progressive with a strict adherence to regulatory principles allows regulation to be tested and policies to be reformed for the purpose of market efficiency. This is the primary reason why it is crucial to understand the purpose of regulation.

*“Many people want the government to protect the consumer; a much more urgent problem is to protect the consumer from the government.” Milton Friedman*

## ***Section 2: Understanding Where We Are***

It is essential for one to understand the purposes of regulation before recommendations can begin. I have already alluded to a few factors that are inherently focused on the goal of decreasing systemic levels of fraudulent activity, market failures and market instability. Politicians and economist alike, use times of systemic crisis to fuel the fires of reform and creation of regulations. I argue, however the idea of continued reform and progressive thought is a more sound approach in the development and maintenance of securities regulations than the current reactive approach fueled by crisis. There are three distinct reasons for improved regulatory reform both domestically and internationally.

### ***2.1 Fraud and Complex Investments***

The first is to decrease the amount of fraudulent investment practices that have plagued the world markets. From the fall of Bernard Madoff’s fifty billion dollar Ponzi scheme to the alleged securities fraud of Stanford Investments, the challenges of the last few quarters are unprecedented and seem insurmountable by most standards.<sup>45</sup> For example, the FBI has opened more than five hundred investigations into corporate fraud, of which included thirty eight cases that involved major firms.<sup>46</sup> Concerning financial institutions, another important investment

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<sup>45</sup> Graybow, Martha. “Reuters.” From Madoff to Standford, sleuths chase assets. 9Mar 2009  
<<http://www.reuters.com/article/domesticNews/idUSTRE5271CZ20090309?feedType=RSS&feedName=domesticNews>>.

<sup>46</sup> Ryan, Jason. “ABC News.” Fraud Directly Related to Financial Crisis Probed. 11 Feb 2009.  
<<http://abcnews.go.com/TheLaw/Economy/story?id=6855179&page=1>>.

concern is to decrease systemic and complex investment practices at the firm and at the exchange level. By enforcing deregulation of complex practices, two pillars of Wall Street, Bear Sterns and Lemman Brothers, were no match against the systemic challenges of the current financial crisis.

Individuals and institutional investors would have never believed that these firms had anything to be concerned about. Some economist have argued that publicly traded companies believed it necessary to put their firms at risk for benefit of higher returns on investment and shareholder approval. Investors look for unattainable long run returns and this further creates the need for the continued development of competitive markets. The 1990's created a desire for 20 and 30 percent return on investment at a consistent basis. As a result, the investing public began to believe that this was a normal pattern and expected this type of market performance in the short-run and in the long-run as well. This type of behavior became internalized by the general public and emerged into corporate leaders as demand for higher returns and greed became prevalent.

There are no investment vehicles that I am aware of that will return this type of performance on a long-term scale. This type of behavior created the need for firms to construct new and complex investment mechanisms. Unfortunately these multifaceted investments and the mismanagement of corporations were a precursor to the complexities of the financial crisis. Consequently, because of the high degree of government beauracracies, few regulations were created to oversee these multifaceted challenges. Complex derivatives and multilayered structured products will create high degrees of unnecessary risk and further underlines the need of disclosure requirements. If these products remain unregulated then they will aide in additional uncertainty and fraudulent activity in both domestic and international markets.

## *2.2 Restoration of Investor Confidence*

Secondly, there is a specific need to restore investor confidence in financial securities and the systems of exchanges that manage our finances. Chairman Mary Schapiro, of the SEC, addressing the Committee of Appropriations of the US House of Representatives, said that investor confidence is the primary focus of the organization. Schapiro suggested a major overhaul to the regulatory mechanism of the SEC, should be conducted immediately. She further stressed a focus on solving impending challenges that are taking place on a global scale. Schapiro also suggested that there is a renewed commitment to protecting investors.<sup>47</sup>

It is important that we rebuild confidence to both domestic and international investors however we must not stymie growth and efficiency within our markets. Without reform in critical areas concerning securities and financial regulation; the investor will not feel safe and confident that systemic issues have been rectified. Consequently, as long as these complex challenges exist we will not see an increase in the flow of capital towards financial securities. Investors in general will continue to keep the majority of their capital in fixed assets such as treasury bills or certificate of deposits compared to moving their money into growth focused investments, such as equities. The goal of our governments, firms, and societies, should be for the flow of capital to have limited constraints, to build effective incentives for further competition and for investors to have a greater degree of confidence in the financial and securities markets.

## *2.3 The Cycle of Business*

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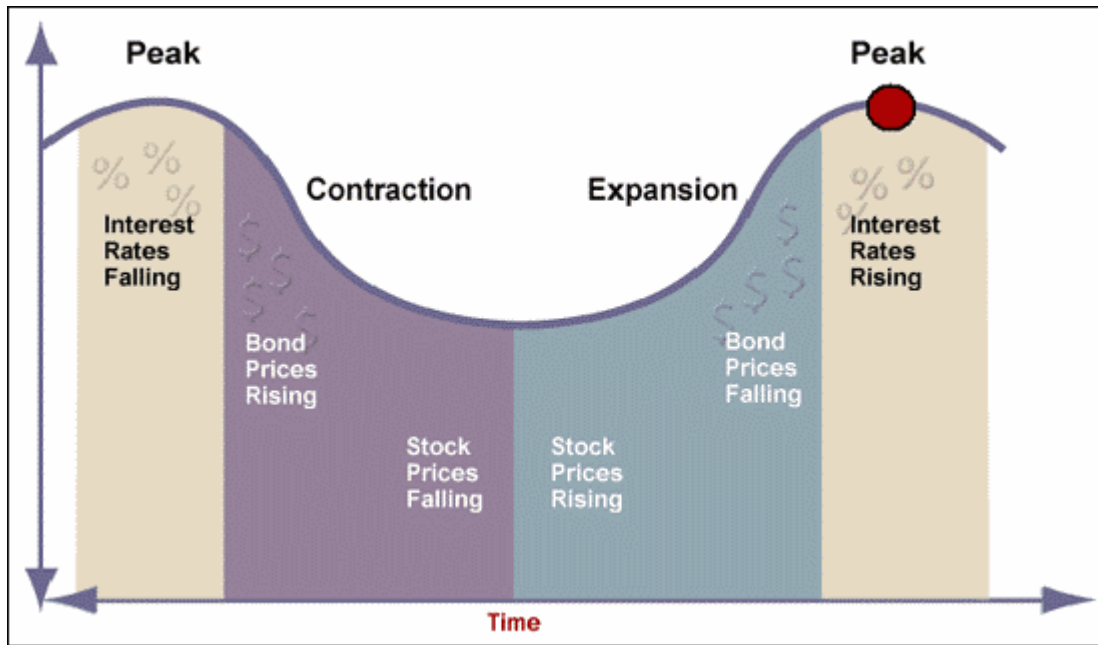
<sup>47</sup> "Securities and Exchange Commission." Testimony Before the Subcommittee on Financial Services and General Government. 11 Mar 2009. <<http://www.sec.gov/news/testimony/2009/ts031109mls.htm>>.



The third plausible reason for improved reform is to develop regulatory mechanisms that will support and manage the economic/business cycle. Consequently, some economists argue to get rid of the business cycles completely; while others call for free and competitive markets which are cyclical by nature. It is well known that cycles or fluctuation occur consistently in economies today. Most economists and politicians believe that in order to effectively manage the business cycle, that they should utilize both monetary and fiscal policy. However, other economists believe that business cycles are essentially normal activities in the market and the constraints of regulation should be reduced if not eliminated. Economist and politicians should not try and rid societies of these cycles but instead focus their efforts in managing the severity of both peaks and troughs.

Consequently, economist, politicians, and social scientist have devoted much time to decreasing the harsh side of business cycles. There have been numerous amounts of research and theories produced over the years, concerning why business cycles happen and how to manage them properly. Arthur F. Burns and Wesley C. Mitchell are the fathers of the business cycle as we know it today. In their book, *Measuring Business Cycles*, the authors underline the definition of business cycles;

“Type of fluctuation found in the aggregate economic activity of nations that organize their work mainly in the business enterprises: a cycle consists of expansions occurring at about the same time in many economic activities, followed by similarly general recessions, contractions and revivals which merge into the expansion phase of the next cycle.” (Burns & Mitchell 468)



Source: Seguin Financial Group, *Economic Cycles*:  
[http://www.seguinfinancial.com/Economic\\_Cycles.htm](http://www.seguinfinancial.com/Economic_Cycles.htm).

There are four main areas of cyclical determinants that make up what economist today use to understand and measure aggregate productivity and employment in business cycles. According to Able, Bernanke, and Croushore, a period during the business cycle when aggregate economic activity is decreasing is a contraction or what is known as a recession. A recession is a depression if the decreased activity remains severe. After reaching the low point or bottom of the contraction, what is known as a trough, the aggregate economic activity begins to increase. When aggregate economic activity increases during the cycle it is known as an expansion. The process from a peak to peak or trough to trough is called a business cycle.<sup>48</sup>

In Keynesian theory the government generally does not wait for natural shocks to improve gross domestic product and full-employment. Keynesian's believe that government spending through fiscal and monetary policy will help generate more demand for goods and

<sup>48</sup> Abel, Bernanke, Croushore. Macroeconomics Sixth Edition. New York: Person 2008.

services even if people are not willing to consume goods.<sup>49</sup> Consequently, Classical economists do not believe in managing economic cycles this way and would prefer that governments allow natural shocks through competition to improve or change economic cycles. Concerning economic cycles, what is the best mechanism of achieving efficiency in the markets and how do we effectively manage the complexities of the business cycle?

There are of course numerous arguments and differing objectives when discussing economic/business cycles. According to Burns and Wesley, many economic indicators move collectively throughout the process of a business cycle. For example, during an expansion output rises and at the same time employment rises. Conversely, during a contraction output of goods and service decline and so does employment. Professor Christian Romer, points out that the term business cycle is a misleading concept. She says that cycle implies that there is some degree of irregularity in the timing and duration of cycle itself. Consequently, most modern day economists refer to the business cycle as fluctuations.<sup>50</sup>

Professor Romer also believes that just as there are no regularities' in the timing of business cycles, there is no reason why cycles have to occur.<sup>51</sup> For example, she believes that an economic activity namely full employment is a place where the economy could essentially stay forever. If nothing disturbs the economy, full-employment level of output, which tends to naturally grow as the population increases and new technologies are discovered, can be

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<sup>49</sup> Radcliffe, Brent. "Investopedia a Forbes Digital Company." Can Keynesian Economics Reduce Boom-Bust Cycles? <<http://www.investopedia.com/articles/economics/08/keynesian-economics.asp>>.

<sup>50</sup> Business Cycles, Christian D Romer, "The Fortune Encyclopedia of Economics." Business Cycles. New York: Time Warner Company, 1993.

<sup>51</sup> Business Cycles, Christian D Romer, "The Fortune Encyclopedia of Economics." Business Cycles. New York: Time Warner Company, 1993.

maintained forever. Business cycles or economic fluctuations occur because of disturbances to the economy.<sup>52</sup> This theory however, would seem to work in academic circles however would be relentlessly challenged in real societies because of the complexities of governments and economies today.

Professor Romer also believes that the cause of volatility in an economy is in direct correlation to policy changes. Recessions are a constant challenge because policy is encouraged to reduce inflationary measures and inflation is a persistent problem because of policy. Consequently, she believes we have replaced the naturally occurring prewar boom-bust cycles with postwar boom-bust cycle driven by policy.<sup>53</sup> If Professor Romer's theory is correct then the type and execution of policy has the ability to effect change in an economy. For this reason, benefit-cost analysis should be used as an efficient way at evaluating the pros and cons associated with policy reform.

#### *2.4 Benefit-Cost Analysis*

According to Professor Paul Portney, Benefit-Cost Analysis or BCA is a theory that was created because economist and politicians alike have identified over the years that policy applied into markets sometimes allocates resources inefficiently. BCA is concurrently used for environmental policies however the theories focus is inherently concerned with gainers and

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<sup>52</sup> Business Cycles, Christian D Romer, "The Fortune Encyclopedia of Economics." Business Cycles. New York: Time Warner Company, 1993.

<sup>53</sup> Romer, Christina D. "Journal of Economic Perspectives." Changes in Business Cycles: Evidence and Explanations. Vol. 13, No.2 Spring 1999. University of California, Berkeley. <[http://elsa.berkeley.edu/~cromer/JEP\\_Spring99.pdf](http://elsa.berkeley.edu/~cromer/JEP_Spring99.pdf)>.

losers. A central philosophy with BCA is the effect of policy adjustments on a society, are more or less the aggregate effects on the individuals who comprise society.<sup>54</sup>

Understanding this, it should not be the objective of policy makers to construct policies and legalities that will constrain economic stability and market efficiency. According to Joskow and Noll economist explain the existence of regulation as to correct market failures and protect improperly informed consumers from impairment.<sup>55</sup> Actors among social regulatory bodies' intentions should essentially be to drive economic growth, stability and limit market failures. As the economies of the world progress so should the regulatory objectives of financial securities underlying both growth and stability.

### *2.5 Changes in the Economy Merit Changes in Regulation*

The financial securities markets cannot operate efficiently without the trust of the individual to institutional investors. The investor needs to have either developed trust or have the capability of past activities to verify the market, exchange and/or corporation are trustworthy. If markets are unbridled with fraudulent and manipulative activities, investors will move their money to find a safer investment option. For example, the investor may purchase a treasury bill or a certificate of deposits at a commercial bank in place of purchasing equities through an exchange. These challenges have increased investor responsibilities and understanding of various investment options.

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<sup>54</sup> Portney, Paul R. "The Concise Encyclopedia of Economics." Benefit-Cost Analysis. 2008. <<http://www.econlib.org/library/Enc/BenefitCostAnalysis.html>>.

<sup>55</sup> Feldstein, Martin. "National Bureau of Economic Research." American Economic Policy in 1980's Paul Joskow and Roger Noll 1981. University of Chicago Press, 1 Sept 1995.

Securities markets are in an extraordinary transitional period. Just a few years ago employees had defined benefit plans where the worker would receive a certain financial award at retirement. Now, the majority of companies rely heavily on defined contribution investment options, where the employees fund their own retirement. This new practice may have consequences not yet understood. The difficulty underlies the fact that enormous amounts of the investors that lost an immense amount of capital in their respective retirement accounts.

In 1975, the value of private pension assets corresponds to only 18% of GDP. Consequently, recent policy changes show pension plan assets represent 60% of GDP, of which 70% is a defined contribution plan.<sup>56</sup> In addition, there has been an increase in institutional ownership from less than 10% in the 1930's to more than 70% in today's market. Fundamentally this shifts the objectives of social regulatory bodies concerned the individual investor to forming policy initiatives around mutual funds, pension funds, and several other asset management funds.<sup>57</sup> These types of problems may have systemic issues concerning market performance centered on an individual's retirement objectives.

If patterns are consistent, those that have 10 to 20 working years left will most likely not have any real challenges in amassing investment capital. Concerning this current financial crisis, investors in retirement or has only a few working years left, will likely not have a chance at recapturing their respective savings. Unfortunately the investor may have to continue to work or possibly downsize their current living standards. Obviously these enormous groups of investors are looking for ways at building back their respective retirement accounts.

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<sup>56</sup> Zingales, Luigi. The Future of Securities regulation. Working Paper. Chicago Booth School of Business, 29 Jan 2009. Chicago: 08-27.

<sup>57</sup> Zingales, Luigi. The Future of Securities regulation. Working Paper. Chicago Booth School of Business, 29 Jan 2009. Chicago: 08-27.

This section outlined the purpose of regulatory reform; to provide growth and stability back into the markets. The purpose of regulation can take multiple forms. There are some branches of economics that continually call for greater levels of regulatory power and oversight; while others are looking for ways to give private markets increased freedom and competition. However if one theory worked all the time we would not have amassed the hundreds of theories we have today, that says differently. So essentially, regulation exists to provide markets with efficiency, stability, growth and integrity.

*“If you don’t visit the bad neighborhoods, the bad neighborhoods are going to visit you.”*

*Thomas Friedman*

### ***Section 3: Understanding Where We Are Going***

The intent of this section is not necessarily to explain in context of where we are headed under domestic and international regulatory framework. However this section is to essentially discuss and develop probable scenarios for where we are going as a country and a global community. This section was created under the normative response to financial crisis and regulatory reform. Some economists believe that response to crisis is a means for regulatory reform. According to Joskow and Noll, economists explain the existence of regulation as to correct market failures and protect inadequately informed consumers from impairment.<sup>58</sup>

#### *3.1 Regulation is Dependent on Crisis*

If this view is correct then we should assume that our independent variable is crisis and our dependent variable is regulation. Essentially, regulation is dependent on crisis in order for social regulatory bodies to construct, reform, and implement new guidelines. According to Joskow and North, all theories in social science builds on concepts of human behavioral assumption or what is better known as rational choice theory.<sup>59</sup> Stating that is important to understand the variables used concerning transaction cost in the development of regulatory reform.

#### *3.2 Transaction Costs*

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<sup>58</sup> Feldstein, Martin. “National Bureau of Economic Research.” American Economic Policy in 1980’s Paul Joskow and Roger Noll 1981. University of Chicago Press, 1 Sept 1995.

<sup>59</sup> North, Douglass. Institution, Institutional Change and Economic Performance. New York: Cambridge University Press, 1990.



Coase, North and Williamson are most notably known for their work on constructing the concepts of transaction cost. Although Coase initially developed the notion of transaction cost, for the purposes of this paper I am going to discuss North's' perspectives. According to North, institutions provide the basic procedures and mechanisms because individuals seek to create order and endeavored to eradicate uncertainty in market exchange. As a result, institutions and technology work in concert to establish transaction and conversion costs. Institutions are therefore creating a mechanism of profitability and feasibility in engaging in economic activity.<sup>60</sup> Without institutions and technology the basic construct of economic activity would be severely inefficient and ineffective.

This type of inefficiency would establish costly outcomes to economic growth and stability. According to North, the cost of information is a key to understanding the costs of transaction; which is consistent concerning the costs of measuring value and the exchange of goods. These costs also are in direct linear relationship with protecting rights and the enforcement of policy agreements.<sup>61</sup> The dichotomy between economic activity and regulation should be modeled at a macro-economic level but broken down to a micro-economic level, of costs that are associated with the exchange of goods and services.

In effect at times there exists a diminishing return of policy reform along the curve as cost outweighs the benefits of increased growth and stability. In order to develop regulatory framework, it is essential to assess the transaction costs concerned in each proposed regulation. The transaction cost would be concerned with states and federal regulatory bodies along side of securities exchange activity.<sup>62</sup> Of course these costs are developed and implemented at a macro level when it should also

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<sup>61</sup> North, Douglass. Institution, Institutional Change and Economic Performance. New York: Cambridge University Press, 1990.

<sup>62</sup> Trachtman, Joel. Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation. Diss. Tufts University, 1999 Medford: See also: Choi & Guzman 1891.

be necessary to understand opportunity costs at an individual level. It is however a mistake to suggest that regulation in itself stymies economic activity or competition completely.

### *3.3 Benefit-Cost Analysis*

Transactional costs are a byproduct of regulation and because of this one must focus on the optimum level of regulatory guidelines for economic activity and competition to continue to be developed. In section two I have alluded to the importance of benefit-cost analysis (BCA) or some similar construct that will allow the policy actor the ability to judge current regulations and the possibility of reform. Therefore we should gain an understanding of just how BCA works and how it can be developed to assist policy makers. It is important to note, while most economic models are at the macro-economic level BCA breaks down activity to the micro-economic or individual level. This is important because at the micro level decisions for policy reform are more quantifiable in their effects towards the markets of individual actors.

BCA essentially measures the change of benefits for those individuals that either were winners or losers through the proposed or already initiated policy. Consequently, benefits are measured by the willingness of the individuals to pay for the perceived economic output while the cost associated with policy is reflected in the amount of compensation required to offset any negative consequences.<sup>63</sup> While BCA is usually used as a normative theory when analyzing environmental policies, it can be useful to analyze other policy reforms as well. When new regulations are constructed and implemented into markets, due diligence is a necessary action.

### *3.4 The Political Economy Approach to Regulatory Reform*

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<sup>63</sup> Portney, Paul R. "The Concise Encyclopedia of Economics." Benefit-Cost Analysis. 2008. <<http://www.econlib.org/library/Enc/BenefitCostAnalysis.html>>.

The political economy approach to regulatory reform has a unique perspective. Currently most regulation is an expressed reaction to crisis. The political economy approach is a proactive action that could cause regulatory bodies to be in front of crisis. The approach attempts to provide a analysis of how and why regulations evolve and how shocks lead to normative policy change. According to Kroszner and Stratmann, there are few items to consider when developing normative theories concerning regulatory reform under the umbrella of welfare policies.<sup>64</sup>

Kroszner, subscribes to three areas, first being education. He believes that the public should be made aware of the potential costs of regulatory reform. Rather than wait for the crisis to unfold and bad policies to be implemented, there should be a more proactive approach concerning reform. Second, Kroszner believes that competition among rival interest groups can increase beneficial reforms. If these rival groups have an incentive to compete against each other in addition to competition with the consumer, they would be less likely to support incompatible and inefficient regulation.

Third he believes that government and regulatory institutions play a crucial role in the development of regulations. Those specific committees in Congress or Parliament with responsibility for banking and financial guidelines will most likely be set up to provide an important debate which will incorporate the evolution of information progression.<sup>65</sup> Consequently, it is not in the regulation itself where challenges may be created it is the lack of institutional assessments after the fact. By creating incentive models for regulatory bodies to be proactive, we will help to reduce future predicaments and decrease the current model of regulation being dependent on crisis. One

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<sup>64</sup> Kroszner and Stratmann. "Interest Group Competition and the Organization of Congress: Theory and Evidence from the Financial Services Political Action Committees," Working Paper. University of Chicago, National Bureau of Economic Research, 1996. Chicago: 1998.

<sup>65</sup> Kroszner, Randall. "On the Political Economy of Banking and Financial Regulatory Reform in Emerging Markets." Working Paper. University of Chicago Graduate School of Business, 1998. Chicago: 1998.

way to do this is by understanding what type of shocks may cause a disturbance in the current equilibrium.<sup>66</sup>

Shocks for example, in an economy will have an effect on elasticity of demand, and this will create or erode economic activity in an underlying society. For example, the increase in technology, regulation and transportation costs has changed the way everyday business is conducted. There was a time not too long ago, where an investor would have to meet with a financial advisor to buy or sell a security in a given exchange or market. However with the development of the internet, investors can simply bring up their on-line self-directed brokerage accounts and initiate a transaction by the click of a button.

Those same transactions that once took a few hours to initiate now only take a few seconds. Institutions are responsible in keeping track and the adherence of regulatory guidelines throughout their respective security exchange systems. An example of this is trading certain types of securities that can only be traded in specific blocks of time. Also with a diminishing need for the financial advisor, transaction costs for the firm were decreased as well. This shock essentially decreases the need for brick and mortar broker dealers and the financial advisor themselves. The competitive landscape is different and a new economy of scale has emerged. This scenario should cause some alarm at the regulatory level concerning investor education.

### *3.5 The Focus on Investor Protection*

The purpose of regulation is to construct a mechanism for investor's protection, market stability and efficiency. Investors will be hesitant to invest in an exchange or market if they are not fully confident that regulatory constructs have been developed in order to create safe and

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<sup>66</sup> Kroszner, Randall. "On the Political Economy of Banking and Financial Regulatory Reform in Emerging Markets." Working Paper. University of Chicago Graduate School of Business, 1998. Chicago: 1998.

efficient markets. This well known trend helps to create incentives for institutions to construct and establish fair and efficient markets as well. At the same time this allows profit minded institutions the ability to focus on providing aid in the further maintenance of efficiency and stability in security markets.

Full disclosure and transparency are at the heart of regulation. However the majority of investors rely much more heavily on how well the security is performing currently or since inception. Out of the hundred or so friends and colleagues I have met over the years, there is only a handful that has ever taken the time to read a balance sheet or the board meeting minutes of the company or fund they own. Therefore disclosure should also be concerned micro-economic modeling and its effects on the individual investor. This highlights a hope that the investor will gain a good understanding of the securities they own.

Currently securities regulation both domestically and internationally provides constructs around a social welfare context. According to Merritt Fox, securities regulation usually encourages the support of the individual investor over the institutional shareholder. They encourage market stability which is essentially macro-economic stability, in a collective action framework while promoting accuracy of capital allocation.<sup>67</sup> This is to say that institutions such as the SEC or the IOSCO should be concerned with investor protection and market efficiency at the macro level while allowing uniform laws at the state level to regulate at the micro level.

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<sup>67</sup> Merritt B. Fox. "The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities." Working Paper: Columbia University School of Law, 1998. New York: MICH. L. REV. 696 (1998).

### *3.6 Uniform Securities Act*

According to John Coffee, state laws do very little in protecting the investor, are usually overshadowed by federal law and are irrelevant to international securities law.<sup>68</sup> State law must however be set up to work in concert with federal law. At sometime in the future, international law should also be required to work under some type of Uniform Securities law as well. The Uniform Securities Act essentially gives the state the responsibility of enforcing securities regulation at the micro level. This networked relationship between federal and state levels could be a prototype of securities law on an international standpoint. Concerning international law, the SEC has begun to work with Canada through the Multijurisdictional Disclosure System.

### *3.7 International Network*

According to Douglas North, the SEC is concerned with fraud in the U.S. capital markets from foreign bodies. The SEC is highly concerned with pressures received to relax regulation of domestic companies and foreign companies. Because of this, the SEC has greater concern with externalities that may influence our market stability and regulatory reform.<sup>69</sup> Understanding this, it is quite significant that MJDS exists between the United States and Canada as a prototype for other countries. This type of network is helping the U.S. to extend its current network of securities regulation, from a domestic to an international context.

Consequently, the European Union has already made significant strides towards this international approach in current financial and banking regulation. With its 27 member states the E.U. is aware of some of the challenges that may exist under taxation, sovereignty and state

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<sup>68</sup>Coffee, John C. "The Future as History: the Prospects for Global Convergence in Corporate Governance and its Implications." Northwestern School of Law, 1 April 1999.

<sup>69</sup> North, Douglas. Structure and Change in Economic History. New York: W.W. Norton & Co, 1982.

specific regulatory constructs.<sup>70</sup> Other areas of concern on a domestic and international level are hedge fund markets, collateralized debt obligations and credit default swaps. These investment vehicles are not currently regulated. For example, credit default swaps have grown from zero to 44 trillion dollars in just ten years, alluding to further disclosure and regulatory needs.<sup>71</sup>

### *3.8 Lack of Transparency*

Securities such as these have little to no collateral posted for these contracts. Companies such as AIG, Citi Bank, and other commercial banks have massive exposure to Credit Default Swaps.<sup>72</sup> Both public and private markets are not closely watched, scrutinized or regulated in the least; and has ultimately helped to cause insurmountable decreased in wealth not only domestically but internationally as well. Once again the argument is raised that it is not regulation that we should be scared of it is what type of regulation that is applied to the markets. These types of securities are too broad and complex for most investors to understand the complexities they represent to firms, which further highlights the need for transparency.

According to Luigi Zingales, the lack of transparency concerning the hedge fund market makes it very difficult to determine whether the performance of the fund is due to trading guidelines, excessive risk taking or chance.<sup>73</sup> Zingales also alludes to the lack of transparency, which can create the suspicion of insider trading and front running. It is also difficult to evaluate

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<sup>70</sup> "The European Union." Key Facts and Figures about Europe and the Europeans." [http://europa.eu/abc/keyfigures/index\\_en.htm](http://europa.eu/abc/keyfigures/index_en.htm).

<sup>71</sup> Zingales, Luigi. Testimony on Causes and Effects of the Lehman Brothers Bankruptcy. Before the Committee on Oversight and Government Reform, United States House of Reps. Washington: 2008.

<sup>72</sup> Zingales, Luigi. Testimony on Causes and Effects of the Lehman Brothers Bankruptcy. Before the Committee on Oversight and Government Reform, United States House of Reps. Washington: 2008.

<sup>73</sup> Zingales, Luigi, The Future of Securities Regulation, Working Paper No. 08-27. University of Chicago NBER and ECGI, 2009. Chicago: 2009.

the systemic effects of their activity. For example just how much are the fund's investments tied into the pro-cyclical economy, other companies and funds alike?<sup>74</sup> Transparency is a necessity when protecting the investor from market instability and fraudulent activity.

### *3.9 Information Management*

Securities regulation is constructed under the context of greater disclosure and transparency. Most will suggest that transparency of securities with no oversight would not be sufficient, as noted above. Some argue that the individual investor does not have the cognitive ability to manage the endless amount of disclosure and research presented on a given company. According to Herbert Simon, cognitive capabilities are a scarce resource that has to be allocated. This is crucial because most people do not have the ability to attend to all information available at the time of the decision.<sup>75</sup>

Another way of looking at this is to assume that the majority will find the most efficient way of acquiring information they perceive to be important in making an investment decision. As a result, people decide how much time and effort to spend on a task and rationally exclude certain types of information. Essentially with limited cognitive constraints it is impossible to consider every piece of information and would make the decision-making process unmanageable and overwhelming.<sup>76</sup> People have limited time, cognitive constraints and are consistently finding

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<sup>74</sup> Zingales, Luigi, The Future of Securities Regulation, Working Paper No. 08-27. University of Chicago NBER and ECGI, 2009. Chicago: 2009.

<sup>75</sup> Fiori, Stefano. Herbert A. Simon and Contemporary Theories of Bounded Rationality. Working Paper Series. University of Turin, Department of Economics, Torino Italy: 2008.

<sup>76</sup> Simon, Herbert. "A Behavioral Model of Rational Choice." The Quarterly Journal of Economics Vol. 69 No. 1 (1955): 99-118.



new ways of efficiency. This highlights the fact that some people will ignore plausible information in lieu of their ultimate objective, performance.

According to Martin Lindstrom's book, *buy-ology*, there is currently a major push in neuroscience to better understand how to market to the consumer. There was a study that was carried out by Dr. Alan Hirsch, where researchers placed identical pairs of Nike running shoes in two separate rooms. One room was pumped full of light floral scents and the other room was not. Volunteers examined the running shoes in each room and then filled out questionnaires. Consequently, 84% of the volunteers preferred the running shoes in the floral scented room.<sup>77</sup>

I am not arguing that we pump floral scents into financial securities however I am drawing the conclusion of how people actually make decisions. Basically these shoes were identical in form and in function; therefore we can conclude that the volunteers preferred the shoes in the floral scented room because of how the scents made them feel. This study shows a strong correlation that people make decisions because of how it makes them feel. How then do we tie this into investments and to securities related regulatory reform? By arguing the fact that it is important the investor feels safe concerning their investment options and the markets they invest in.

Is it really that essential that we offer unending amounts of information and research to the consumer or investor? According to Professor Paredes, if the buyer does not internalize the information given, even if the aggregate benefits exceed the cost of producing the information, the buyer will not demand this information.<sup>78</sup> This creates the need for a monopoly in regards to

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<sup>77</sup> Lindstrom, Martin. buy-ology Truth and Lies About Why We Buy, New York: Doubleday, 2008.

<sup>78</sup> Paredes, Troy, Blinded by the light: Information Overload and its Consequences for Securities Regulation. Faculty Working Papers Series No. 03-02-02. Washington University School of Law, 2003. Saint Louis: 2003.

research and regulation. With limited time and cognitive constraints people are looking for a one stop shop that will adequately provide information, disclosure and transparency, so that the investor can make a well educated decision.

### *3.10 Glass-Steagall Act*

The Glass-Steagall Act was first introduced in 1933 post-depression era as a way of separating investments and commercial banking. The reason for this was concluded that banks in the pre-depression era were considered to be too speculative with consumer capital.<sup>79</sup> This paper fundamentally raises awareness for a form of Glass-Steagall Act regulation, in the separation of mutual funds in a defined contribution plan. It also highlights the need for the creation of specialized mutual funds for retirement purposes only. The reason for this separation is that the individual investors are taking on too much exposure to risk with the very money that will sustain his or her family through retirement.

During the past two decades the numbers of defined contribution plans have increased quite dramatically, while defined benefit plans have been consistently decreasing.<sup>80</sup> The number of employees with a defined contribution plan has risen considerably from 11.5 million to 30.1 million since 1990<sup>81</sup> This shows the direction of retirement accounts in general and the need to focus our energies towards correct asset allocation models and investor education. The goal is that risk adverse individuals will reach a higher level of utility under a defined contribution plan

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<sup>79</sup> Gross, Daniel. "Shattering Glass Steagall." *News Week*. 2008. <<http://www.newsweek.com/id/159092>>. See also, Heakal, Reem. "What Was the Glass-Steagall Act?" *Investopedia A Forbes Digital Company*. <http://www.investopedia.com/articles/03/071603.asp>.

<sup>80</sup> Poterba, Rauh, Venti and Wise. *Defined Contribution Plans, Defined Benefit Plans, and the Accumulation of Retirement Wealth*. Working Paper. 12597 National Bureau of Economic Research. 2006.

<sup>81</sup> "Department of Labor." *Form 5500 Filings*. 2008. <<http://www.dol.gov/EBSA/5500MAIN.HTML>>.

than under a defined benefits plan. For savvy investors this statement is even more correct.<sup>82</sup> To further highlight this, the average level of wealth accumulated in defined contribution plans depend primarily on investor asset allocation models.<sup>83</sup>

It is also a well known fact that defined contribution providers have severe time constraints to officially advise the participant on what investments might be advantageous to reach their respective retirement goals. Defined contribution providers generally give one or two advisors responsibility of thousands of plan participants. These advisors usually deliver some general marketing materials for investor participation and skim through current securities regulation. The advisor will also try and define the investor's respective asset allocation model. However the investor consistently feels overwhelmed and inadequate in making decision as to where they should invest their money.

This has created an enormous educational gap, requiring the individual investor to essentially attain a high degree of knowledge concerning investment options and retirement goals. With an increase in investment terminology and complexities, we are pushing the individual investor into increase risk exposure in their retirement accounts. According to Jeremy Siegel, the market returns on an historical basis only 5 to 7 percent.<sup>84</sup> If the market generally return is 5 to 7 percent, why should we expose the investor, in their defined contribution

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<sup>82</sup> Poterba, Rauh, Venti and Wise. Defined Contribution Plans, Defined Benefit Plans, and the Accumulation of Retirement Wealth. Working Paper. 12597 National Bureau of Economic Research. 2006.

<sup>83</sup> Mangiero, Susan. Pension Report Card - Process, Not Point in Time Numbers. 19 Nov. 2008. <<http://www.pensionriskmatters.com/articles/asset-allocation/>>.

<sup>84</sup> Siegel, Jeremy. "Timely Investment Insights with Dr. Jeremy Siegel." Wells Fargo Advisors. WEB Radio to Wells Fargo Advisors. Saint Louis. 25 Mar. 2009. [https://my.advisorconnection.com/infomax/PCG/marketing/marketing\\_news/norep/investor\\_ed\\_series/infomax-pcg\\_announcement-0325-siegelwebcast.pdf?srcApp=search](https://my.advisorconnection.com/infomax/PCG/marketing/marketing_news/norep/investor_ed_series/infomax-pcg_announcement-0325-siegelwebcast.pdf?srcApp=search)>.

accounts, to the risk of aggressive and volatile investment options, when a more conservative approach will do?

We are placing too much responsibility on the investor; by requiring they make quality financial decisions having time and knowledge constraints. The money invested in retirement accounts should be separated from speculative investments and placed in a very conservative investment option. If the investor wants to be exposed to greater risk with the potential of higher returns than the investor should open separate investment accounts in addition to their retirement account. One perspective might be that the investors retirement account should be invested in a long-term conservative asset allocation model only, which would give the investor the capacity to have a clearer picture of their saving at retirement.

### *3.11 Corporate Governance*

The argument then raises the question, are strong corporations willing to structure their firms around shareholders interest? I have already alluded to the fact that shareholders have internalized the need for high returns on their investments and on a long-term scale. Corporations have also internalized this behavior in their quest for growth and increased share value. Let's assume that most corporations seek to maximize share value and that managers will seek growth opportunities to align with shareholder interests. If this is the case then there are a few theories to note.

In well established countries that have a system of securities regulation, the investor has disclosure rights and feels more aware of practices surrounding the company they are investing in. Corporation and shareholder interests are likely to be aligned in countries in which the

shareholder has disclosure rights of the corporation's financial statements and performance.<sup>85</sup>

The marginal investors in these countries will not be willing to purchase shares when they know that some shareholders have greater access to disclosure than they do. As a result of this scenario corporate managers will most likely only issue a limited number of shares. One way to combat this is through lobbying.

If the underlying country has a system of laws and regulations then it is assumed that lobbying may allow smaller groups to exert political influence on regulation and/or legislation.<sup>86</sup> Lobbying could essentially occur at the firm level, through the corporation's board members. This however will depend on each company individually and will further construct the argument for micro-level policy reform. Unfortunately, some board members of companies especially in the U.S. have lost power to managers of the corporations.

This would be ill-fated to shareholders; if they are seeking outside advice to help manage the firm's directives. However the shareholder is only concerned with an increase in share value, then the management philosophy is seen as an efficient and effective construct. According to Berle and Means, in their book, *the Modern Corporation*, there are a number of reasons for this shift in power from board members to managers. Berle and Means, believe that the focus of firms became how to manage the complexities of the corporation and how to further build shareholder interest from outside the firm. This created the need for professional and skilled management.<sup>87</sup>

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<sup>85</sup> Gugler, Mueller and Yurtoglu. "European Corporate Governance Institute." Corporate Governance and the Returns on Investment. Working Paper No. 06/2003. University of Vienna: 2003.

<sup>86</sup> Grossman and Helpman. "Protection for Sale." American Economic Review Vol. 84, No. 4. (1994) 833-850.

<sup>87</sup> Mizruchi, Mark S. The American Corporate Network. Beverly Hills: Sage Publications, 1982.

Berle and Means also argued that the rise of the modern corporation has introduced a level playing field with the modern state. They believe that the future may hold true to an action by the corporation that may even supersede the state as a dominate form of social organization.<sup>88</sup> One other theory concerning this important construct is this level of dominance that institutional stockholders have in corporations. Useem, suggests that the institutional stockholder constructed a degree of power and authority in U.S. corporations of today.<sup>89</sup>

This power and authority originates from the standpoint of a greater equity positions and has a greater influence on corporate decisions. If this trend is consistent then institutional stockholders, could very likely become a voice for those that invest in their respective funds. Essentially the institutions would argue in defense of fair and orderly firm practices because the firm is operating with institutional money, which came from the holders of their investment fund. Finally concerning corporate structure, with increasing globalization of our financial markets, national governments have lost the ability to regulate some business communities.<sup>90</sup> This is to say that globalization has created a new playing field, that best practices of our past may not be the best today; and will require continual reform and improvement.

### *3.12 Competition in Securities Regulation*

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<sup>88</sup> Adolph Berle and Gardomer Means, The Modern Corporation and Private Property. United States: Transaction Publishers, 1932.

<sup>89</sup> Useem, Michael. Investor Capitalism, How Money Mangers are Changing the Face of Corporate America. United States: Basic Books, 1999.  
[http://books.google.com/books?id=2kFUMQlBAxgC&dq=Useem,+Investor+Capitalism.&printsec=frontcover&source=bn&hl=en&ei=unR4SsuGKNqntge3je2WCQ&sa=X&oi=book\\_result&ct=result&resnum=4#](http://books.google.com/books?id=2kFUMQlBAxgC&dq=Useem,+Investor+Capitalism.&printsec=frontcover&source=bn&hl=en&ei=unR4SsuGKNqntge3je2WCQ&sa=X&oi=book_result&ct=result&resnum=4#). See also: Berle and Means revisited: the governance and power of large U.S. corporations, Mizruchi, Mark. *University of Michigan* April 2004.

<sup>90</sup> Jeffrey Frieden, “Invested Interests: The Politics of National Economic Policies in a World of Global Finance.” Harvard University School of Government, (Cambridge: Cambridge University Press, 45 (1991): 425-451.

Economist and politicians alike are consistently looking for a regulatory mechanism that will allow further growth and development in our economies today. Globalization has increased the size and scope of the markets and presented a whole new level of concern. We are seeing a tremendous opportunity for growth however this also presents the need for regulatory action on an international scale. Concerning this new opportunity there are many challenges and numerous theories in the implementation of such a task. One theory that has received some attention recently is competition among regulatory bodies.

Some economist believe that competition among financial and securities regulators would be quite useful and would most likely result in a higher degree of regulation among private business, then what is present today.<sup>91</sup> Current securities law is based on a rule of law perspective and not necessarily giving incentives to regulatory bodies to adjust because of a competitive advantage. Consequently, it is up to the supporters of competition between federal and state regulatory bodies in U.S. and E.U. to validate its necessity.<sup>92</sup> The question becomes, is competition the best means at creating a regulatory mechanism for the protection of investors and market efficiency?

The argument for competition has numerous fundamental theories and deeply held opinions. Some believe that without competition there are no real mechanisms of incentives for economic growth and stability. While others believe that strictly adhering to regulatory constructs will increase stability of the markets and investor protection. At this point we know that competition involves numerous complexities and with limited time and financial constraints,

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<sup>91</sup> Karmel, Roberta. Reconciling Federal and State Interests in Securities Regulation in the United States and Europe. Center for the Study of International Business Law at Brooklyn Law School, 11 Dec. 2002. New York: 2002.

<sup>92</sup> Karmel, Roberta. Reconciling Federal and State Interests in Securities Regulation in the United States and Europe. Center for the Study of International Business Law at Brooklyn Law School, 11 Dec. 2002. New York: 2002.

people are looking for ways to increase utility at the most efficient and effective ways. Competition among regulatory bodies may create a new economy of scale with investors that are willing to pay more for better regulatory screening and disclosure.

The government is also a substantial actor involved in the shaping of competition among regulatory bodies. Whether we are speaking of judicial legislators or regulatory actors themselves, competition within their ranks will provide a vehicle for debate to establish best practices. Competition among regulatory bodies will help in decreasing fraudulent activity as well. Competition will essentially construct an incentive model that will further reform current practices and detect fraud on continual basis. This further defends the argument of regulations being constructed around a practice of consistent reform.

### *3.13 Domestic and International Regulatory Competition*

Fraud, insider trading and corporate misconduct are now an international issue unlike ever before. If a U.S. corporation commits fraud then very likely the result of the action will spill over to the global community. Our world is networked together almost forcing each country to work together for the benefit of each other. If fraudulent activity continues to infiltrate itself further into the U.S. and world markets, then the underlying integrity of the markets will be up for debate. This may result in reduced liquidity, raising the cost of capital and further jeopardizing the world financial markets. These actions consequently impose externalities on private investors around the world.<sup>93</sup>

The work of the Financial Service Authority, International Accounting Standards Board and International Organization of Securities Commissions are important to developing a sound platform in the construction of international securities regulation. These organizations have helped to develop platforms for debate and the establishment of far reaching networks. The interrelated challenge with

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<sup>93</sup> Pierre Salmon, "The Logic of Pressure Groups and the Structure of the Public." European Journal of Political Economy 3 (1987): 55-86.



developing and enforcing regulation has been quite difficult in drawing lines of responsibility. For instance, if someone from a foreign country committed fraud in U.S. markets, is it the foreign country, the U.S. or both countries responsibility? Is it the country where the person is from or is it the responsibility of the U.S. to provide regulatory constructs that will keep this activity from creating externalities in the markets? This argument will continue for years to come.

According to Trachtman, the challenge of unstable equilibrium and externalities essentially creates the need to address a much greater problem, and that is regulatory jurisdiction. What is the most efficient mechanism for internalizing externalities, such as securities fraud?<sup>94</sup> This question will be answered by each country individually. By forging regulatory responsibility or jurisdiction on the country receiving the externality, would consequently demand that the country accepts responsibility. This would be done by joining an international regulatory body and letting go of certain degrees of autonomy, as far as jurisdictional authority is concerned.

### *3.14 Issuer Choice and Regulatory Competition*

However a possible idea in defense of issuer mobility in world markets is the theory of issuer choice. One theory is for both domestic and international issuers to have the option to inter into a U.S. or foreign securities market, and avoid application of federal securities regulations.<sup>95</sup> Professors such as Roberta Romano, believes that the current system of securities regulation which enforces uniform disclosure guidelines on all issuers, have essentially stymied growth and efficiency in the

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<sup>94</sup> Trachtman, Joel. Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation. Fletcher School of Law and Diplomacy, Tufts University, Massachusetts: 1999.

<sup>95</sup> Romano, Roberta. Empowering Investors: A Market Approach to Securities Regulation. Yale University School of Law, 1998. Romano is concerned with competition in securities regulation within the United States most generally; however her further study extends to international constructs of transactions and foreign issuers of securities.

securities markets.<sup>96</sup> Professor Romano is essentially stating that in her view, we can find a better way of issuing new securities and providing a stable and efficient market on an international scale.

Professor Romano goes on to explain; British retail investors might purchase common stock in a French company by placing an order through a British broker that has access to the Paris Bourse. This new regulatory construct would allow issuers to choose what jurisdictional system of securities regulation they prefer.<sup>97</sup> This construct would be a way to lay the framework for competition among nations around the world, in seeking to provide a mechanism for the most efficient and stable markets. If governments and regulatory actors are consistently constructing and requiring competition among firms at the micro-level, why not require a similar policy among regulatory actors in our globalized world, at the macro-level? After all globalization has essentially created a competitive playing field among the nations or world.

In order for issuer choice and regulatory competition to occur, both the opportunity for issuers to choose regulatory establishments and an effective price mechanism must be established. According to Howell Jackson, there must be a systemic policy in place that allows legal entities the opportunity to choose among regulatory regimes.<sup>98</sup> Essentially, government and regulatory actors should open their doors to opportunities to choose regulatory constructs that fit the issuer's objectives. Also the transaction cost associated with the choice of regulatory regimes, has to be economical in order for entities participation.<sup>99</sup> If the transaction costs for issuing a security with a

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<sup>96</sup> Romano, *supra* note 94, Professor Yale Law School.

<sup>97</sup> Romano, *supra* note 94, Professor Yale Law School.

<sup>98</sup> Jackson, Howell. "Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – Part 1." Harvard University School of Law, Massachusetts: 2001.

<sup>99</sup> Wymeersch, Eddy. A Landmark Decision in European Company Law. University of Ghent Financial Law Institute Working Paper 99-15 Belgium: 1999.

certain regulatory establishment are too high; then the issuer will most likely choose the lesser cost regulatory institution.

One way this may not be true, would be in the case that the issuer is marketing their security to a certain type of investor. This would not be true if the issuer is looking to market their security to an investor looking for market stability and consistent growth patterns. Then the issuer would look for a more closely held stringent regulatory organization that will most likely necessitate higher transaction costs. These costs would essentially be passed onto the investor not necessarily held at the firm level. Generally the investor would understand the cost to purchase this type of security as being higher because of the regulatory protection and stability that these organizations offer.

Issuer choice and competitive securities regulation assumes numerous challenges. Some of these challenges entail what regulatory constructs will be responsible for in the oversight of these organizations and is there a need for oversight given the competition among them? Chiefly among them would be if governments are willing to relinquish a certain degree of autonomy to allow competitive risk among the regulatory organizations? For example, once held premiere organization may or may not be all that effective and significant. According to Frank Easterbrook, An interesting problem occurs from the fact that government itself may be a mechanism that constructs inappropriate constraints on competition.<sup>100</sup> Easterbrook's argument is of course against government intrusion at least to a certain degree.

Or maybe another way of looking at this would be what level of government intrusion would allow markets to experience efficiency yet remain effective concerning investor protection and disclosure rights? However, even if governments are willing to relinquish autonomy concerning regulatory competition and jurisdictional oversight, there is still the problem of

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<sup>100</sup> Frank H. Easterbrook, Federalism and European Business law de Gruyter-Recht 1996. *Easterbrook has written many articles concerning various laws such as antitrust law, criminal law and legal action involving the securities markets. Other writings include, The Economic Structure of Corporate Law.*

cooperation among organizations. The question remains, as to what extent are governments and regulatory actors willing to cooperate and to establish regulatory mechanisms that will construct efficient and stable markets?

In this section I have further clarified a number of suggestions concerning domestic and international securities regulation. These suggestions are meant to spark intellectual critique and further scholarly debate. This section was constructed under the context of suggestive material and plausible normative solutions for securities regulation. This article may well have a presumptive position throughout its context but it further highlights the need for consistent regulatory reform. It is important that markets remain efficient and stable while allowing for economic growth and development.

*“It may be laid down as a primary position, and the basis of our system, that every Citizen who enjoys the protection of a Free Government, owes not only a proportion of his property, but even of his personal services to the defense of it.” [George Washington](#)*

*Conclusion:*

It is not just the responsibility of governments or regulatory actors to construct mechanisms that will help to enforce reasonable and equitable standards among citizens and non-citizens alike. It is the responsibility of us all to work in concert, in the establishment and active execution of the regulatory standards in our markets. Corporations, financial advisors, regulators, investors and governments around the world all share in this responsibility. In this paper I have highlighted numerous suggestions that I hope will initiate further scholarly debate. However it is essentially that we focus on a few elements that this paper does suggest as sound indicative principles.

Securities regulatory reform should not be a reaction to crisis. Securities regulation should be an adherence to ideological principles of integrity, efficiency, and stability. If regulation is merely a reaction to crisis then there are two theories implicated. The first is that regulatory actors must not have a clear understanding of the purpose of securities regulation. This is to say, there are still those among us which believe that regulation is primarily a mechanism that is only concerned with investor protection. They seem to not fully comprehend that regulation should be a systemic construct created around the framework of efficiency.

For example if investors feel that the securities markets are filled with fraudulent activity and corporate misconduct, then they are more likely to stay away from investing altogether. If investors feel they are not getting full and fair disclosure of publicly traded firms, then they will most likely not invest in those firms either. However, if regulatory organizations establish complex constraints and inefficient regulatory oversight, then the transaction costs of doing

business will be too high. Consequently future business activities and competitive incentives will also decrease.

Sure, one the purposes of securities regulation is to provide necessary constructs in protecting investors from unwanted externalities; however regulatory reform should be created in the framework of efficient markets. Secondly, citizens, governments and regulatory actors on a domestic level should review the philosophies and ideologies that formed the foundational principles of their respective country. Guiding principles in the United States, such as freedom, integrity and the pursuit of happiness are some of the fundamentals that helped to construct the country, to what it is today. With the onslaught of increased globalization and the very real problem of non-assimilation of immigrants, countries have got to know who they are and what they stand for.

This is essential to the reform of securities regulations, not only domestically but also internationally. Once this is known then regulatory bodies have a framework to construct and reform regulation to fit their respective ideologies. Full and fair disclosure should be implemented on an international scale. Disclosure is an international challenge and should be met with the utmost respect. What or who defines monetary and fiscal policies and who should regulate the markets, if so how? Does the underlying country have a market of integrity or should they allow fraudulent activity to be rampant throughout their markets? Knowing who we are will aid in the construction and reform of regulations.

If the U.S., China or France is for example of a country that is truly concerned with integrity? Then integrity should be a forced mechanism for consistent regulatory reform in our markets.

Credit Default Swaps would be a prime example of this. Going from zero to a 44 trillion dollar market in only ten years with absolutely no regulatory oversight, is appalling and irreprehensible. Why were there no real attempts of regulatory oversight on a security such as this? If government and regulatory bodies agree to the ideological principles that guide and define their respective countries; then these bodies will have the framework in place for consistent measures of reform. This fundamental principle will help keep regulation from being formed around crisis and allow ideological principles to be catalysts of reform. I know this is idealistic to state and defend, however it essential that we make real and quantifiable progress in this direction.

The financial crisis and current policy agendas will set the framework that will develop new and improved theories to institute stability, confidence and productivity into domestic and international securities markets. A system of effective securities regulation will be the catalyst for increasing market efficiency and investment growth. Consequently, effective securities regulation has a direct correlation on market efficiency and investment growth. By making strides in the creation of competitive incentives concerning regulatory bodies we will essentially present an answer to problems associated in the domestic and international securities markets.

This article defends numerous schools of economics, and highlights the importance of both macro and micro economic policies. It also defends regulatory oversight to protect investors from fraudulent activity. However it is the intention of this article to underline the fundamental principle, which states the answer to the financial crisis, is not one sided. Capitalism should still have an important place in our markets but capitalism must be met with the structure of effective and efficient regulatory framework. We must not only construct and consistently reform regulation at the macro-level but also at the micro-level, where real people

live and work every day. The primary reason for regulation is efficiency incorporating the underlying principals of stability, growth, and integrity.



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