PART I

THE CAPITAL MARKETS: AN OVERVIEW

CHAPTER 1
THE INSTITUTIONAL AND REGULATORY FRAMEWORK

SECTION 1. THE GOALS OF SECURITIES REGULATION

The federal securities laws regulate some, but not all, of the financial markets. Chiefly, they focus on those markets that allocate capital, moving it from savers through financial intermediaries (e.g., underwriters, dealers, and other financial firms) to users (i.e., those who have productive uses for capital and are willing to pay a competitive return). Although this process of intermediation between the savers and users of capital will be a primary focus of this book, the financial markets perform other functions as well. For example, the derivative markets permit their users to hedge risks (for example, the risks of interest rate or currency fluctuations or commodity price changes), but also to speculate. Highly diverse in structure and operation, financial markets link very different suppliers of capital with principally corporate borrowers; in some markets, retail investors are common, while in others they are largely excluded in favor of sophisticated institutional investors.

Given these differences, it does not follow that all markets should be regulated identically or even equally intensively. In some, private ordering may
be feasible, and the need for governmental oversight may seem minimal. Although no simple generalization can explain the historical contingencies that have caused the federal securities laws to apply only to certain markets, American securities regulation clearly varies the intensity of its regulatory supervision depending on the extent of individual investor participation in the particular market. This Chapter seeks to provide an abbreviated roadmap, first, of the principal financial markets to which the federal securities laws apply; second, of how these markets typically work and the forces changing them; and, third, of the interwoven web of regulatory institutions—federal, state, and “self regulatory”—that collectively regulate these markets, usually in cooperation, but sometimes in conflict.

Initially, however, there is an antecedent question: why regulate? The fact that a market is very large does not alone imply that a federal administrative agency should be created to oversee it. Many markets are adequately controlled simply by the common law of fraud, and, even among financial markets, there are some enormous markets that function with very little governmental regulation (for example, the currency market or the market for government securities). A distinctive feature of American securities regulation is that it goes beyond simply proscribing fraud and requiring affirmative disclosure in connection with the issuance of securities, but in addition also establishes a detailed and mandatory system of continuing, periodic disclosure with which “public” companies must comply. This continuing disclosure system focuses on the “secondary” market in which investors trade with each other as well as on the “primary” market in which issuers sell securities to investors. Why should securities markets be regulated in this pervasive fashion? Although this is a topic of some controversy among academics (with some believing the current level of regulation is excessive), the justifications for such a mandatory disclosure system generally rely on some combination of the following factors:

1. **Consumer Protection.** Historically, the securities markets have long been thought to be affected with a special public interest. The first federal securities laws were passed during the early years of the Great Depression, following the stock market collapse in October 1929. Congress believed not only that investors had been systematically misled and overreached during the go-go decade of the 1920’s, but also that the 1929 stock market collapse had been a principal cause of the Depression and that the Depression had been prolonged by the lack of confidence in the market on the part of investors (with the result that solvent corporations with good prospects could not raise capital). These twin concerns—that investors were vulnerable in a manipulated marketplace and that others suffered when investors disinvested in the market—explain why Congress declared in Section 2 of the Securities Exchange Act of 1934 that

1. The House Report accompanying the Securities Act of 1933 examined the decade after World War I and concluded:

   “Fully half or $50,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities.”


2. In recent years, historians have tended to assign greater causal weight to other events, such as the Hawley–Smoot Tariff Act of 1930 and a resulting trade war, in the causation of the Depression. See John H. Jackson, The World Trading System: Law and Policy of International Relations (1992) at 31. Under this view, the 1929 stock market crash may have precipitated an economic decline, but other developments exacerbated and extended it.
"transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions."³

The political judgment seemed at the time obvious: When Wall Street sneezed (as it did massively in October, 1929), the rest of America could become seriously ill. As a result, Congress established the Securities and Exchange Commission ("SEC") as an independent federal regulatory agency and gave it strong enforcement powers to serve as the "police of Wall Street."

Since 1929, there have been other sudden stock market declines (most notably, the 2008 financial crisis, which will be discussed shortly). Indeed, the financial meltdown in 2008, which uniquely originated in the debt markets, once again appears to have demonstrated the close relationship between the capital markets and national economic health.

Arguably, the justification for a paternalistic approach is in one respect stronger today than in 1929. Before the passage of the federal securities laws, only a relatively small percentage of the American public invested in securities (and even less in equity securities). Today, half of all U.S. households own equities, either directly or through mutual funds, up from about one fifth of all households in 1983.⁴ Even more significant may be the fact that nearly three-fourths of Americans’ liquid financial assets today are invested in securities-related products (e.g., stocks, bonds, and particularly mutual funds), with the balance held in bank deposits and certificates of deposit.⁵ Between 1930 and 2005, the number of households owning equities through employer-sponsored retirement plans grew by 5.2 million.⁶ In short, the majority of the American middle class has invested its retirement savings, directly or indirectly, in the stock market (and no longer in bank savings accounts) and is thus more exposed than in 1929 to the possibility of a severe stock market decline. Given this heavy investment in equity securities, commentators agree that a stock market crash would have severe consequences for the real economy.⁷

³. Spelling out this critique in more detail on the face of the Securities Exchange Act of 1934, Section 2(3) states:

"Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, ..."

Section 2(4) of the 1934 Act then adds:

"National emergencies, which produce widespread unemployment and the dislocation of trade, transportation and industry and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified and prolonged by manipulation and sudden and unreasonable fluctuations of securities prices on such exchanges and markets ..."

⁴. See Investment Company Institute and the Securities Industry Association, Equity Ownership in America, 2005 (2005) at 1. As of 2000, the NYSE estimated that 84 million individual Americans owned shares, either directly or indirectly through mutual funds or self-directed retirement plans. See NYSE, SHAREOWNERSHIP, 2000 at 10. In contrast, the number of shareholders in Germany in 2000 was estimated at 6.2 million, up from 3.9 million in 1997, but still way below the U.S. on a percentage basis. See Norman Poser, The Stock Exchanges of the United States and Europe: Automation, Globalization, And Consolidation, 22 U. Pa. J. of Int’l Econ. & Bus. 497 n.3 (2002).


Nonetheless, the approach generally adopted by the federal securities laws is far from paternalistic. Rather, believing in investor self-determination, the federal securities laws permit high-risk products to be sold, even to retail investors, so long as full disclosure is made.

2. *Systemic Risk and Financial Stability.* The 2008 financial crisis showed that financial institutions are closely interconnected, knitted together by derivatives in a web of risk-sharing transactions, with the result that the failure of one can imply the failure of many. Because financial institutions are thus “too interconnected to fail,” the failure of the first can trigger a cascade of falling financial institutions and paralyze the economy. Although the SEC does not have jurisdiction over the capital adequacy of most financial institutions, it did have authority over the “shadow banks”—i.e., the large investment banks that were required to register with it as broker-dealers (this category includes Lehman, which went bankrupt, and Bear Stearns and Merrill Lynch, which were acquired by larger banks on the brink of collapse). The SEC was charged with ensuring their capital adequacy and monitoring their safety and soundness and risk management practices. Studying the 2008 crisis, the Financial Crisis Inquiry Commission (the body created by Congress to study the crisis) concluded that the SEC had failed (along with other regulatory agencies) to meet its responsibilities in this regard, and the Dodd–Frank Act of 2010 (which is discussed later in this Chapter) has attempted to strengthen regulatory oversight.

Still, the proper structure for U.S. financial regulation remains in debate. Although protection of financial stability is a common concern for all financial regulators, the structure of financial regulation differs widely across nations. In some (such as the U.K.), there is a single financial regulator for all financial institutions (banks, broker-dealers, insurance companies, mutual funds, etc.), whereas in others there is a “twin peaks” structure, with the consumer protection function being deliberately separated from the prudential financial regulatory function. Each is assigned to a different agency (for fear of conflicts arising between these two different roles). The United States is unique in the degree to which it has a fragmented system of functional regulation with a different regulator for each class of institution (with the SEC regulating broker-dealers, but not banks or insurance companies). Recently, much commentary has suggested that the U.S. has tolerated an overly fragmented system of financial regulation, which invites “capture” by the industry and permits financial institutions to engage in regulatory arbitrage and seek the most lenient regulator. In 2008, the U.S. Department of the Treasury released a study calling for consolidation of financial regulation, but, although Congress considered the re-organization of financial regulators, it has largely left the existing highly fragmented structure intact.


10. Sec 7 J. Legal 2 contracts.
3. The Informational Needs of Investors. Many markets sell essentially fungible products (wheat, oil, diamonds, etc.) whose grade and characteristics can be specified without great difficulty. Also, most transactions in these markets occur between professionals who expect to do business with each other again and hence value their commercial reputation for honesty and fair dealing. Even in other markets where transactions are not as easily standardized, self-help remedies, including personal inspection, are often available (e.g., one can kick the tires at an automobile showroom or squeeze the tomatoes in the supermarket). Such self-help is less feasible, however, in the case of securities. Not only is it impossible for the typical buyer to examine the company, but the value of the security depends heavily on the likely future earnings of the issuing corporation (or other entity). Thus, the investor wants reliable information about the issuer’s financial condition, its likely future earnings, its competitive position, the status of its products in their own marketplaces, its prospective contingent liabilities, the background and competence of its management—and a host of other matters. And the investor needs this information to be presented in a relatively standardized and uniform fashion to facilitate comparisons among securities. Absent such disclosures, it is questionable whether most investors would be willing to invest funds in risky enterprises, and it is certain that they would reduce the price that they are willing to pay in direct proportion to their level of uncertainty about the firm’s value. Possibly for this reason, the level of disclosure required in securities markets has historically exceeded the level of disclosure generally required by the law of contract or fraud. In short, for the securities market to function efficiently, much more disclosure is required than in most other markets. For reasons discussed later in Chapter 3, this optimal level of disclosure may require governmental action and subsidization, principally because of the “public good”—like character of securities information. As a generalization, “public goods” tend to be underprovided, and so mandatory regulation may be needed.

4. Inadequate Incentives to Disclose. Conceivably, individual securities markets could solve the informational needs of investors without direct governmental intervention, by adopting minimum listing standards for securities traded on them. In fact, the New York Stock Exchange imposed such requirements on its listed companies for several decades prior to the passage of the federal securities laws (although there is some debate as to whether they enforced their own requirements consistently before they became subject to SEC oversight in the 1930s). Still, managers may resist disclosure of adverse information about their firm for any of a variety of self-interested reasons (even if it were in the long-term interest of the firm to maintain its credibility by disclosing such information). Not only do managers fear that the revelation of adverse information could lead to their ouster (or, at least, to reduced compensation), but they may also fear that disclosure of some forms of information will cause proprietary injury to their firm by alerting competitors, as well as investors, to important developments. Hence, one important rationale for a mandatory disclosure system is that the private costs of disclosure can exceed its social costs, thus leading to lesser disclosure under a private ordering system in which each firm chose its own level of disclosure than under a mandatory

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system. In short, a socially optimal level of disclosure may only be achievable through mandatory law.\footnote{11}

In addition, in a world characterized by competing securities markets, achieving consensus on the format of, and minimum standards for, disclosure has proven difficult—much more so today than in the days when the NYSE had an effective monopoly over trading in companies listed with it. Governmental coordination may be the simplest way to specify a mutually desired common standard.

5. **Allocative Efficiency.** Another important (and, to many, the critical) function of the federal securities laws is to ensure the accuracy of securities prices. By “accuracy”, economists mean stock prices that conform to the fundamental value of the companies traded.\footnote{12} This goal is considered important, even apart from the goal of investor protection, because the capital markets allocate a scarce resource (capital) among competing users. By determining the cost of capital for corporate issuers, the securities markets serve in theory as the nerve center for a capitalist economy, encouraging the flow of capital to firms with superior prospects and penalizing less efficient firms by requiring them to pay more for capital. In this view, the capital markets, and in particular the stock market, promote efficiency and economic growth and thereby benefit all citizens, not simply investors. The more that one takes this view, the more that one can justify a disclosure system having higher costs than rational issuers themselves would voluntarily incur in order to satisfy investors because, from this perspective, there is a public or social benefit that exceeds the private benefits of disclosure.

In recent years, this view has been hotly debated. Some argue that securities markets are characterized by excessive speculative trading, which does not benefit society or improve efficiency but does result in the deadweight loss of high transaction costs.\footnote{13} Others believe that while the goal of “accuracy enhancement” is valid, it must be balanced against the corporate issuer’s own interests in confidentiality.\footnote{14} Their primary fear is that excessively high disclosure standards will result in disclosures that the firm’s competitors can exploit. For example, while disclosure of future business plans or new products should enhance the accuracy of securities prices, it may also allow competitors to mimic those plans; over time, this could reduce the incentive to invest in research and development. From this perspective, “accuracy enhancement is only one of a number of conflicting objectives which must be considered . . . .”\footnote{15}

\footnote{11. For this argument, see Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment, 85 Va. L. Rev. 1335 (1999).}


\footnote{14. See Edmund Kitch, The Theory and Practice of Securities Disclosure, 81 Brooklyn L.Rev. 763 (1995). In essence, this argument is the other side of the coin to Professor Fox’s argument that the private costs of disclosure exceed its social costs. See, Fox, supra note 13.}

\footnote{15. Kitch, supra note 14, at 773.}
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Controversy also exists over whether the federal securities laws have enhanced market efficiency. Some argue that by arming investors with private causes of action for fraud that give rise to the prospect of significant liability, the federal securities laws “reduce the amount of information that is provided by issuers.” This view rests on the premise that market forces alone would elicit a near optimal level of disclosure. This claim overlaps with a lengthy debate about whether, historically, the introduction of the federal securities laws actually increased the amount of disclosure made available to investors. Proponents of mandatory disclosure respond that the most recent empirical evidence shows that mandatory disclosure has improved market efficiency.

6. Corporate Governance and "Agency Costs." Disclosure not only informs securities prices, it permits shareholders to gain greater control over their corporate managers. This is an alternative efficiency justification for the mandatory disclosure system established by the federal securities laws, and some commentators see it as the more persuasive justification. Under this interpretation, the principal purpose of mandatory disclosure is to address "agency cost" problems that arise between stock promoters and investors, and between corporate managers and shareholders, by reducing the shareholders' cost of monitoring these agents (in particular, by mandating disclosure of the self-interested use of corporate assets by managers and promoters).

Proponents of this "agency cost" model argue, however, that it justifies a considerably different disclosure system than that which an "allocative efficiency" model would justify, and they criticize the present-day Securities and Exchange Commission ("SEC") for deviating from the model that they believe makes greater sense.

7. Economic Growth, Innovation, and Access to Capital. Not all industrial societies organize their economies around stock markets; indeed, active securities markets may be more the exception than the rule. Germany and Japan

16. Id. at 770.


18. One important recent study has found that the SEC’s introduction in the early 1980’s of its required “Management Discussion and Analysis of Financial Condition and Results of Operations,” which mandated the disclosure of certain forward-looking information, improved the accuracy of share pricing in the U.S. equity markets. See Merritt Fox, Artymo Durnev, Randall Morck, and Bernard Yeung, Law, Share Price Accuracy and Economic Performance: The New Evidence, 102 Mich. L. Rev. 331 (2003).


20. Agency costs are those costs incurred to control inappropriate behavior in a principal-agent relationship, plus the residual cost of agent opportunism that is not cost effective to deter or prevent. See Michael Jensen & William Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J.Fin.Econ. 305 (1976).

21. See Mahoney, supra note 19, at 1048.
represent industrial systems that appear to be more bank-centered than securities market-centered (although each has an active stock market). Yet, there is some evidence that countries with an active stock market experience more rapid economic growth. Even apart from the issue of relative growth rates, a significant qualitative difference is evident in the structure and performance of bank-centered versus market-centered economies: bank-centered systems tend to produce a more centralized system, with greater industrial consolidation and fewer new entrants. In contrast, economies that are organized around securities markets tend to favor new entrants, in particular start-up and venture capital companies that convince the market that a new technological innovation developed by them merits equity capital. Thus, it may not be coincidental that Silicon Valley developed in the United States, not in Germany or Japan. In contrast, in bank-centered systems, there may be pressure for an entrepreneur with a new innovation to merge, or otherwise become affiliated with a larger corporate group as a precondition to bank finance. From this perspective, it is at least a plausible hypothesis that a legal system that facilitates and encourages an active equity securities market may also promote a more decentralized economy and a more rapid pace of technological innovation.

8. Maintaining a Competitive Market and the Relative Cost of Capital. In a global economy, issuers and investors can increasingly choose the market in which they wish to participate. If regulatory costs are higher in one market than another, issuers will predictably prefer the lower cost market—even if that market has a higher cost of capital. The cost of capital should rise to the extent that investors face greater uncertainty and so demand a correspondingly higher rate of return to compensate them for bearing increased risk. As a result, there is a tradeoff between regulatory costs and benefits, and a balance must be struck. Today, unlike in the less globalized past, “overregulation” is more likely to cause issuers to flee a market and to dissuade foreign issuers from cross-listing in such a more expensive market, but “underregulation” can produce a higher cost of capital, which can dampen the economy, reduce Gross Domestic Product (“GDP”), and potentially increase unemployment. Thus, an underappreciated goal of securities regulation may be to decrease the cost of capital by reducing informational asymmetry and increasing transparency. The optimal point where marginal costs and marginal benefits just balance is always elusive and debatable.

This problem of balance has become more acute in the wake of the passage of the Sarbanes–Oxley Act of 2002 and the Dodd–Frank Act of 2010. Some of their provisions—most notably Section 404 of the Sarbanes–Oxley Act, which required an annual audit of internal controls—significantly raised costs, particularly for smaller issuers, and has caused some foreign issuers to leave, or not

22. For the argument that economies organized around a securities-based capital market are more able to channel capital to emerging firms and to spur economic growth in transitional countries, see Brown, Of Brokers, Banks and the Case for Regulatory Intervention in Russian Securities Markets, 32 Stan. J.Int’l L.Rev. 185 (1996). The recent experience of several Asian countries (most notably Korea, Taiwan, and Singapore) is often cited to support this generalization. Correspondingly, those countries (including some in Eastern Europe) that have experienced difficulties in the transition to liberalism have often had extremely underregulated securities markets, which in some cases have virtually collapsed because of fraud and investor distrust. See Coffee, Privatization and Corporate Governance: The Lessons from Securities Market Failure, 25 J. Corp. L. 1 (1999).

enter, the U.S. securities markets. For example in recent years, many of the largest IPOs (or “initial public offerings”) did not list in the U.S. In 2000, nine out of every ten dollars raised by foreign companies through new stock offerings were raised in the United States, but in 2005, this pattern was reversed, with nine out of ten dollars raised by foreign companies through new listings occurring outside the United States, principally in Europe.

This evidence should be kept in perspective. The United States capital market remains the world’s largest, accounting for 31 percent of global equity market capitalization as of 2011, but this percentage has declined significantly. Arguably, the first responsibility of regulators is to maintain investor confidence in their own market, not to attract foreign listings. But regulatory costs do impose a constraint, and in a fully globalized world in which few barriers existed to the international movement of capital, domestic issuers, as well as foreign issuers, might flee a market in which regulatory costs were excessively high. In turn, this possibility invites “regulatory arbitrage”—the relaxing of regulatory standards by one jurisdiction in order to attract listings and business to its own market. Such a strategy may be highly competitive in attracting business over the short-term, but may also result in an eventual stock market crash (as many attribute the 2008 crisis in part to rapid and excessive deregulation).

Neither this Chapter nor this Casebook can resolve the foregoing issues, but they are raised here to suggest at the outset the sizable social stake involved in the design of a securities disclosure system. The more investors doubt or distrust the reliability of financial information that they are provided by issuers, the more they will demand a higher return as compensation for this uncertainty. Thus, any loss in investor confidence implies a higher cost of capital. Yet, if securities laws can increase investor confidence—whether through deterrent remedies, mandated disclosure, or administrative supervision—and thereby reduce the cost of capital, they benefit not only investors and issuers, but all of society, including non-investors, because a reduced cost of capital implies greater economic growth. In this respect, securities regulation performs an important public function that goes beyond simply protecting investors.

Section 2. An Overview of the Financial Markets

The securities markets are a subset of the broader financial markets that operate both within the United States and internationally. The federal securities laws apply unevenly to these financial markets, sometimes requiring the issuer of the security to enter their mandatory disclosure system, sometimes only prohibiting fraud, and sometimes not applying at all. This contrast is emphasized at the outset for several different reasons:

24. See Testimony of Donald Evans, Former Secretary of Commerce, before the Subcommittee on Capital Markets, Insurance and GSEs of the House Financial Services Committee on April 6, 2006 at p. 5.

25. Id. at p. 6.

26. This statistic is down from 45% in the period between 1990-2006. See www.capmkts.reg.org/pdfs/2012.