lender of last resort, and this may add to the impending panic if a major financial institution begins to totter on the brink of insolvency.\textsuperscript{156}

\section{4. The Regulatory Framework}

\textit{Introduction.} Financial regulation in the United States has long been organized along functional lines with a different regulator for each class of financial institution. In addition, the U.S.’s federalist structure enables many financial institutions to elect whether to be regulated at the state or federal level. This combination of a functional approach and federalism has resulted in a highly fragmented regulatory structure. For example, at the federal level, five agencies use to share regulatory and examination authority over banks and similar depository institutions: (1) the Office of the Controller of the Currency ("OCC"); (2) the Board of Governors of the Federal Reserve System ("Federal Reserve"); (3) the Federal Deposit Insurance Corporation ("FDIC"); (4) the Office of Thrift Supervision ("OTS"); and (5) the National Credit Union Administration ("NCUA"). The Dodd-Frank Act has eliminated only one of these agencies (the OTS), and it also failed to combine the SEC and the CFTC (as the Treasury Department had proposed in 2008). Thus, it left a fragmented structure largely intact.

This same pattern of fragmented regulation does not prevail outside the United States. Some (but not all) countries have a unified financial regulator, which has authority over the banking, insurance, securities and investment advice fields, as well as pension funds. Other countries (Australia and The Netherlands being leading examples) follow a "twin peaks" model which creates one agency to oversee financial institutions with a view to monitoring their financial soundness and safety and another to supervise their business conduct and assure investor protection. This bifurcated structure is based on the concern that a unified agency may give undue attention to protecting the financial solvency of the banks at the cost of investor protection (because in some circumstances these two goals can work at cross purposes\textsuperscript{157}).

Authority for the oversight and regulation of the securities markets is even more fragmented than in the case of the banking industry. Partly for historical reasons and partly because of the U.S.’s federal structure, authority over the securities industry is shared among three levels of regulators: (1) the Securities and Exchange Commission, a federal administrative agency established by the Securities Exchange Act of 1934; (2) self-regulatory organizations ("SROs"), of which the most important is the Financial Industry Regulatory Authority ("FINRA"), which is the product of a 2007 merger between the regulatory arm of the NYSE and the National Association of Securities Dealers (NASD) and to which virtually all broker-dealers are required by law to belong; and (3) state securities commissioners or other state officials who enforce state securities statutes popularly known as the “Blue Sky laws.” Even this description is incomplete, because the U.S. also distinguishes between “securities” and “fut-

\textsuperscript{156} For a fuller discussion of this problem under the Dodd-Frank Act, see John C. Coﬁen, Jr., Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight, 111 Colum. L. Rev. 795 (2011).

\textsuperscript{157} For example, a liberal litigation remedy permitting injured investors to sue underwriters and broker-dealers may work against the goal of ensuring the financial soundness of the financial institutions that would be the defendants in this litigation.
turers” and assigns the regulation of the latter (along with most over-the-counter derivatives) to the Commodities Futures Trading Commission (“CFTC”), which is an independent federal administrative agency, modeled along the same lines as the SEC. No other country makes this distinction between securities and futures. Compounding these line drawing problems, the Dodd–Frank Act now divides swaps between these same two agencies, giving “security-based swaps” to the SEC and other swaps to the CFTC.

The United States’ pattern of regulatory authority divided along functional lines has been in place for many decades, but has increasingly drawn criticism that it produces a slow and Balkanized regulatory structure that detracts from the competitiveness of the U.S. capital markets. In 2008, the U.S. Department of the Treasury proposed a major consolidation of financial regulatory agencies, opting for a “twin peaks” model that separated prudential supervision from business conduct regulation and investor protection. But Treasury’s “blueprint” for reform did not convince Congress, and Dodd–Frank largely left the existing regulatory structure intact.

The Securities and Exchange Commission. An independent non-partisan agency created by the Securities Exchange Act of 1934, the SEC administers and enforces the federal securities laws. Above all, the SEC’s primary responsibilities are to ensure that the securities markets are fair and honest and to provide investors with adequate disclosure. Organizationally, the Commission is composed of five members: a Chairman and four Commissioners. Commission members are appointed by the President, with the advice and consent of the Senate, for five-year terms. The Chairman is designated by the President. Terms are staggered; one expires on June 5th of every year. Not more than three members may be of the same political party. Although the President appoints SEC Commissioners, the President may not remove a Commissioner, except for good cause.

While the foregoing nutshell description covers the basics, it leaves out the SEC’s essential role: it is the tough cop of Wall Street. Historically, the SEC has acquired a reputation for zeal, integrity, and imagination that distinguishes it from many other federal regulatory agencies. Yet, over some recent periods (in particular, the 1990s), the SEC has been chronically underfunded (as the size of the market and its enforcement obligations have expanded while its staff has remained relatively constant).

Organizational Structure. Internally, the SEC is organized into four principal divisions and several important advisory offices:

The Division of Corporation Finance has the overall responsibility of ensuring that disclosure requirements are met by issuers registered with the Commission. Much of its work involves the review of registration statements for public offerings, quarterly and annual reports from publicly held companies, proxy statements, tender offer documents, and related filings in mergers and acquisitions. It also has the primary responsibility for rendering administrative interpretations of the Securities Act of 1933.

The Division of Trading and Markets oversees the secondary trading markets, including the registration and performance of stock exchanges, broker-dealers, and other participants in these markets (such as transfer agents.

158. For a fuller discussion of the “single peak” versus the “twin peaks” model, see John C. Coffee, Jr. and Hillary Sale, supra note 153; see also Treasury Department, supra note 9.
lender of last resort, and this may add to the impending panic if a major financial institution begins to totter on the brink of insolvency.\footnote{156}

Section 4. The Regulatory Framework

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\footnote{157} For example, a liberal litigation remedy permitting injured investors to sue underwriters and broker-dealers may work against the goal of ensuring the financial soundness of the financial institutions that would be the defendants in this litigation.
Managements of these and other financial institutions, including the SEC, have been exercising varying degrees of regulatory authority with respect to financial products. However, the SEC's authority has been limited to areas such as trading, investment management, and issuance of registered securities. Additionally, the SEC has been criticized for its slow response to the 2008 financial crisis.

The Dodd-Frank Act of 2010 aimed to address these issues by creating a new independent agency, the CFTC, which oversees commodity derivatives. This act also aimed to increase transparency and regulation of the financial markets. The CFTC's role is to ensure the integrity and stability of the commodity futures markets and to protect the public from fraud, manipulation, and abusive trading practices.

The SEC and the CFTC are both independent agencies, and their independence is critical to their ability to effectively perform their regulatory functions. The SEC is responsible for regulating the securities and exchange markets, while the CFTC is responsible for regulating commodity futures and option markets.

The SEC regulates over-the-counter derivatives, which are financial instruments that are not traded on an exchange. These derivatives are often complex and can be highly leveraged, which can lead to significant losses for investors. The Dodd-Frank Act required the SEC to develop rules for these instruments.

The SEC's primary responsibility is to ensure that the securities markets are fair and honest, and to provide investors with adequate disclosure. The SEC is also responsible for enforcing federal securities laws and regulations. The SEC is organized into four principal divisions and several important advisory offices.

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- Trust Indenture Act of 1939;
- Investment Company Act of 1940; and
- Investment Advisers Act of 1940.

Other statutes—most notably “The Public Company Accounting Reform and Investor Protection Act of 2002” (better known as the “Sarbanes–Oxley Act”) and the Dodd–Frank Act—were enacted largely in response to recent scandals and market collapses, but most (but not all) of their provisions amended and expanded the scope and orientation of the Securities Exchange Act of 1934. Therefore, they are discussed below under the heading of that Act.

The 1933 Act. Chapters 2 and 3 of this Casebook focus on the Securities Act of 1933. Essentially, it prohibits the offer or sale of a security (except in certain exempt transactions) unless the security has been registered with the SEC; it also requires the delivery of a prospectus to a purchaser and to other persons to whom a written offer is made. Very favorable causes of action are given to purchasers of securities if the registration statement contains a materially misleading statement or omits to disclose material information (see § 11 of the 1933 Act) or if other material misstatements or omissions, including oral ones, are made by a seller (§ 12(2) of the 1933 Act).

The 1934 Act. The Securities Exchange Act of 1934 covers a far broader terrain than does the 1933 Act. Publicly held companies must enter the SEC’s continuous disclosure system and file annual and quarterly reports with the SEC, and they also must distribute proxy statements before soliciting shareholder proxies or votes. The 1934 Act also sets up a self-regulatory organization for the supervision of the trading markets and gives the SEC oversight jurisdiction over both the stock exchanges and FINRA, which is the principal self-regulatory body for broker-dealers. Under § 15 of the 1934 Act, virtually all broker-dealers must register with the SEC, which has very broad rulemaking powers to define and proscribe practices of broker-dealers that it considers to be “manipulative, deceptive or otherwise fraudulent.” Also, under Sections 7 and 8, the 1934 Act regulates the credit available for securities purchases—known as margin—by authorizing the Federal Reserve to establish limits on the amount of credit that can be extended in connection with a securities purchase.

The 1934 Act has been frequently amended; indeed, it has become the Christmas tree on which Congress almost annually hangs a new ornament in the form of new amendments. Among the most important amendments have been:

1. the Williams Act, passed in 1968, which amended Sections 13 and 14 to regulate tender offers and the control acquisition process;

2. the Securities Investor Protection Corporation, which was created by virtue of a 1970 amendment in order to establish an analogue to the Federal Deposit Insurance Corporation and thereby protect investors from the risk that their brokerage firms would become insolvent (or, as in the Bernard Madoff scandal, that money given to the broker for securities would instead be lost in a Ponzi scheme);

3. the 1975 Securities Acts Amendments, which seeks to establish a “National Market System”;

4. Section 15B, passed in 1975, which created the Municipal Securities Rulemaking Board and established minimal disclosure standards for municipal securities;
(5) Section 30A, added in 1977 by the Foreign Corrupt Practices Act, which both mandates that publicly held firms satisfy and maintain internal accounting controls and prohibits bribery, both foreign and domestic;

(6) Section 15C, passed in 1986, which brings government securities brokers under the limited oversight of the SEC;

(7) the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988, which amended § 21A of the '34 Act to establish civil penalties and related sanctions for insider trading;

(8) the Securities Law Enforcement Remedies Act of 1990, which gave the Commission civil penalties, including a “cease and desist” power, that it could impose administratively;

(9) the Private Securities Litigation Reform Act of 1995, which, based upon the perception that much private securities litigation was abusive or frivolous, created a safe harbor for forward-looking information for certain corporate issuers, heightened the pleading standards, and erected other procedural barriers that a private plaintiff must satisfy in order to state a cause of action; and

(10) the National Securities Markets Improvements Act of 1996, which partially preempted state securities law (thereby significantly revising the allocation of authority between federal and state regulators) and also vastly increased the scope of the SEC’s exemptive authority (thereby conferring broad authority on the SEC to scale back its own requirements in cases or categories where it believes regulation is unwarranted). To date, the SEC has been cautious about using this new exemptive authority, but attitudes could change with each new Administration.

The Public Company Accounting Reform and Investor Protection Act of 2002 (the Sarbanes–Oxley Act). Passed in 2002 in the wake of the Enron, WorldCom and other recent corporate scandals that highlighted accounting and financial reporting irregularities by major public corporations, this statute (popularly known as the Sarbanes–Oxley Act) broadly amends the '34 Act in a far-reaching effort to improve financial reporting by public companies, impose tighter oversight over the accounting profession, and regulate some areas of corporate governance that were formerly left to the states. Toward this end, the Act does the following:

1. creates a self-regulatory body, the “Public Company Accounting Oversight Board,” to regulate the accounting profession, establish auditing standards, and impose appropriate discipline in a manner that parallels the Financial Industry Regulatory Authority’s (“FINRA”) oversight of, and authority over, the brokerage industry;

2. restricts the consulting and other services that an audit firm can provide to an audit client in the belief that such other services create a conflict of interest that may permit the client to induce the auditor to acquiesce in dubious accounting policies by offering lucrative consulting services to a “cooperative” auditing firm;

3. mandates that a public company’s audit committee be composed exclusively of independent directors (as defined by the Act) and strengthens the
powers and responsibilities of the audit committee, requiring that it (and not management or the full board) "be directly responsible for the appointment, compensation, and oversight of the work" of the outside auditors;

4. mandates that public companies prepare (and their auditors audit) a new disclosure document, known as an "internal control report," which evaluates the adequacy of the company's "internal control structure;"

5. seeks to increase auditor independence by (i) requiring the mandatory rotation of the lead audit partner at the audit firm at least every five years and (ii) disqualifying any former employee of the audit firm from serving as a senior financial executive of a former client for at least one year after leaving the audit firm;

6. instructs the SEC to promulgate rules of practice that require attorneys appearing before it to report "evidence" of material securities law violations, fiduciary breaches or similar misconduct to a "reporting" company's chief legal counsel or CEO and, if those officers fail to act "appropriately," to the company's audit committee, its independent directors, or the board of directors as a whole;

7. requires the chief executive officers ("CEOs") and chief financial officers ("CFOs") of "reporting companies" to provide on a continuing basis a prescribed certification of their company's financial statements and imposes greatly enhanced criminal sanctions for certifications that are knowingly false;

8. requires "reporting" companies to make more current, "real time" disclosure of material changes in their financial condition and to report all material off-balance sheet transactions, arrangements, and other relationships that might have a material effect on the current or future financial health of the company;

9. amends § 16(b) of the Exchange Act to obligate corporate directors, principal stockholders and officers to disclose transactions in their company's securities within two business days;

10. instructs the SEC to promulgate rules governing the independence and objectivity of securities analysts and protecting analysts from retaliation by their firms because of negative research or ratings;

11. bars public companies from making "personal loans" to directors or senior executives and forbids them from trading in the company's stock during "blackout periods" when holders of individual retirement accounts are barred from trading;

12. extends the statute of limitations for securities fraud suits;

13. protects "whistleblowers" through new criminal penalties and a private right of action for compensatory damages; and

14. creates a forfeiture penalty under which the chief executive officer and chief financial officer must disgorge to the company all incentive, bonus or equity compensation received, or any trading profits made, during a period in which the company's earnings were overstated.

The Dodd-Frank Wall Street Reform and Consumer Protection Act.\textsuperscript{102} Passed in 2010, the Dodd–Frank Act contains a potpourri of provisions, but its focus is on reducing systemic risk at large financial institutions, while also

\textsuperscript{102} Public Law no. 111–203, 124 Stat. 1376 (2010). This casebook will refer to this statute as the Dodd–Frank Act.
averting any future public bailout of these institutions. Arguably, these two principal goals are in some tension.

Towards these ends, the Dodd–Frank Act does the following:

1. The FSOC, Title I of the Dodd–Frank Act creates the Financial Stability Oversight Council (“FSOC”) to monitor potential threats to the financial system. The chairs of both the SEC and the CFTC are made members of the FSOC, which is in turn chaired by the Secretary of the Treasury. The FSOC is specifically authorized to subject non-bank financial companies (such as Lehman and AIG) to more stringent regulation.

2. Orderly Liquidation Authority. As an alternative to a public bailout, Title II establishes a procedure for liquidation of a systemically significant financial institution. If the Secretary of the Treasury (after consultation with the President and specified other regulators) determines that liquidation of the institution is necessary to mitigate serious adverse effects on financial stability in the United States, the Secretary may appoint the Federal Deposit Insurance Corporation (“FDIC”) as receiver to liquidate the financial institution in a manner that mitigates the risks to financial stability. Effectively, the FDIC already has this power with regard to commercial banks, but the Dodd–Frank Act extends it to nonbank financial institutions, with the difference that no prefunded reserve is created. The FDIC may borrow from the Treasury and the Federal Reserve (and thus may to an extent bailout bondholders), and then impose the costs retroactively through risk-based assessments on large financial institutions. Although the announced goal of this procedure is to avert a public bailout, Congress was not willing to assess a tax on financial institutions to prefund a reserve fund (as it did originally in creating the FDIC).

3. Registration of Hedge Funds. Title IV of the Dodd–Frank Act requires the registration with the SEC of large hedge funds by eliminating the “private adviser” exemption to the Investment Advisers Act of 1940, and it expands the reporting requirements for investment advisers.\textsuperscript{163} Advisers of private funds remain exempted if they have less than $150 million in assets under management,\textsuperscript{164} and investment advisers are subjected to federal regulation if their assets under management exceeds $100 million (smaller funds are permitted to register with their principal state).\textsuperscript{165}

4. Over-the-Counter Derivatives. Title VII of the Dodd–Frank Act assigns the CFTC supervisory jurisdiction over swaps and the SEC jurisdiction over “security-based swaps.” The two Commissions will register participants in this market, including dealers, clearing agencies, exchanges, swap execution facilities, trade repositories, and other major participants. The regulatory framework contemplates:

\textsuperscript{163} See Section 403 of the Dodd–Frank Act (amending Section 203(h) of the Investment Advisers Act of 1940).

\textsuperscript{164} See Section 408 of the Dodd–Frank Act (amending Section 203(b) of the Investment Advisers Act of 1940).

\textsuperscript{165} See Section 410 of the Dodd–Frank Act (amending Section 203A of the Investment Advisers Act of 1940).
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a. mandatory clearing of swaps and security-based swaps for those trades deemed eligible for clearing (as determined both by the clearinghouses and the regulators);

b. mandatory trading on an exchange or swap execution facility if the transaction is cleared and a facility will accept it for trading;

c. public reporting of all cleared and uncleared swaps and security-based swaps;

d. the imposition of capital adequacy and margin requirements by regulators on dealers and major swap participants;

e. new prohibitions against market manipulation;

f. position limits on certain swap contracts in order to restrict manipulation.

5. Investor Protection. Title IX of the Dodd-Frank Act authorizes the SEC to (a) promulgate rules imposing a common fiduciary duty on broker-dealers and investment advisers to protect retail customers,\(^{166}\) (previously, only the latter were generally subject to a fiduciary duty); (b) restrict pre-dispute mandatory arbitration (which clauses appear in most agreements between broker-dealers and retail customers),\(^ {167}\) and (c) adopt rules protecting whistleblowers and enhancing the incentives for them to report securities violations by authorizing bounties to be paid to a successful whistleblower of between 10% and 30% of the amount collected by the SEC (if that amount exceeds $1 million).\(^ {168}\) In addition, the Act enhances SEC enforcement authority by (a) lowering the intent standard in SEC actions against aiders and abettors of securities violations from “knowingly” to “recklessly”;\(^ {169}\) (b) authorizing broad use by the SEC of administrative proceedings before administrative law judges;\(^ {170}\) (c) simplifying the issuance of subpoenas and authorizes the sharing by the SEC with other authorities.\(^ {171}\)

6. Credit Rating Agencies. Subtitle C of Title IX gives the SEC greatly expanded powers over the nationally recognized statistical rating organizations (“NRSROs”). NRSROs—which include the three major credit rating agencies (Moody’s, Standard & Poor’s and Fitch)—had been required to register with the SEC since 2005, but the SEC had relatively little authority over them. A new Office of Credit Ratings is

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\(^{166}\) See Section 913 of the Dodd-Frank Act (amending Section 15 of the Securities Exchange Act of 1934).

\(^{167}\) See Section 921 of the Dodd-Frank Act (adding Section 15(o) to the Securities Exchange Act of 1934).

\(^{168}\) See Section 922 of the Dodd-Frank Act (adding Section 21F to the Securities Exchange Act of 1934).


authorized to examine NRSROs at least annually and to promulgate rules requiring NRSROs, among other things, to (1) set up internal controls over the process for determining credit ratings, (2) establish independent boards of directors; (3) develop universal ratings across asset classes and types of issuers; (4) adopt new professional standards requiring rating analysts to pass qualifying exams and satisfy continuing education requirements; (5) observe certain conflict of interest standards that separate those marketing the firm’s services from those performing the ratings of securities.\textsuperscript{172} The Dodd–Frank Act compromised, however, on whether to end the current “issuer pays” system under which the party issuing the securities pays for the rating and instead instructed the SEC to complete a study by mid-2012 (after which it was authorized, if it chose, to bar the issuer from choosing its rating agency in the case of structured finance products).\textsuperscript{173} Finally, the Act adopts a new liability provision under which private investors may sue credit rating agencies and may survive a motion to dismiss so long as they can allege a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain a similar analysis from an independent source.\textsuperscript{174} This was a response to the broad perception that credit rating agencies had failed to conduct adequate due diligence on rating securities.

7. Corporate Governance and Executive Compensation. Title IX further authorizes the SEC to adopt rules (which the SEC has done) permitting shareholders to nominate candidates for an issuer’s board of directors and to have such candidates listed on the issuer’s own proxy materials (which would both economize on the costs of conducting a proxy fight and possibly give greater credibility to such insurgent candidates).\textsuperscript{175} In addition, following the British practice, Title IX gave shareholders an advisory vote (which must occur at least every three years) on executive compensation and also an advisory vote on golden parachutes (these votes are known as “say on pay” and “say on parachute” votes, respectively).\textsuperscript{176} Independence standards were also specified for the compensation committees\textsuperscript{177} (Sarbanes–Oxley had earlier done this for the audit and nominating committees), and special disclosures were required about the relationship between executive compensation and the corporation’s financial performance. Policies were mandated requiring the “clawback” of bonuses erroneously paid

\textsuperscript{172} See Sections 931 to 939H of the Dodd–Frank Act (amending Section 15E of the Securities Exchange Act of 1934).

\textsuperscript{173} See Section 939F of the Dodd–Frank Act.

\textsuperscript{174} See Section 933 of the Dodd–Frank Act (amending Sections 15E(m) and 21D of the Securities Exchange Act of 1934). In response, the SEC adopted Rule 14a–11, which is discussed in more detail later in Chapter 17, but the rule has been invalidated by the D.C. Circuit on the grounds that the SEC conducted an inadequate cost/benefit study in adopting it. See Business Roundtable v. Securities and Exchange Commission, 647 F.3d 1144 (D.C. Cir. 2011).

\textsuperscript{175} See Section 971 of the Dodd–Frank Act (amending Section 14(a) of the Securities Exchange Act of 1934).

\textsuperscript{176} See Section 951 of the Dodd–Frank Act (adding new Section 14A to the Securities Exchange Act of 1934).

\textsuperscript{177} See Section 962 of the Dodd–Frank Act (adding new Section 10A to the Securities Exchange Act of 1934).
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omulate to executives based in financial statements that were later restated. In addition, federal regulators were given authority to monitor and restrict incentive-based compensation at certain systemically significant financial institutions, prohibiting those arrangements that they determined could have serious adverse effects on economic conditions or financial stability. Finally, brokers who are not the beneficial owners of a security are prohibited from voting them on behalf of the beneficial holder without such person's express instruction.

8. Asset-Backed Securitizations. Title IX further requires securitizers to retain an economic interest in a material portion of the credit risk for any asset that securitizers sell or transfer to third parties. This risk retention—or "skin-in-the-game" requirement—is intended to minimize the moral hazard problem that may have arisen in the securitization of subprime mortgages. Regulators are authorized to determine the amount of this risk retention requirement, and how it applies to different financial assets.

The Dodd-Frank Act has a number of other controversial provisions (including its Bureau of Consumer Financial Protection) but they are omitted from this overview because they do not directly relate to the securities or capital markets.

The other federal securities statutes are substantially less important than the Securities Act of 1933 and the Securities Exchange Act of 1934, but they do closely regulate some special markets and relationships:

The Public Utility Holding Company Act of 1935. Although no longer an important statute because the SEC has largely deregulated the field, this statute required public utility holding companies (as defined) to secure approval from the Commission before issuing securities or otherwise changing their financial structures. The Act chiefly applies to interstate holding companies engaged, through subsidiaries, in the electric utility industry or in the retail distribution of natural or manufactured gas. Detailed reporting and SEC approvals were formerly required for most significant corporate action by such holding companies.

The Trust Indenture Act. The Trust Indenture Act of 1939 ("TIA") has a limited but important focus. It applies to public offerings of debt securities in excess of $1 million and essentially specifies the form of indenture which must be used, including many of the substantive terms that must be set forth in the indenture. The trust indenture is the contract establishing the duties of the trustee who monitors and enforces the contractual rights of the bondholders. Basically the TIA attempts to prohibit the selection of a trustee with a disablting conflict of interest and establishes standards of conduct and responsibility for the trustee.

179. See Section 956 of the Dodd-Frank Act.
180. See Section 957 of the Dodd-Frank Act (amending Section 6(b) of the Securities Exchange Act of 1934).
The Investment Company Act of 1940. Investment companies—which term includes both “open end” and “closed end” mutual funds and money market funds—are companies that hold and manage a portfolio of securities for investment. Increasingly, middle-class Americans buy shares in mutual funds, rather than attempting to pick stocks directly themselves. The Investment Company Act specifies substantive corporate governance standards for the operation of such investment companies, including maintaining an independent board, providing for an annual review of the management contract between the investment company and its investment adviser, subjecting certain transactions between the investment company and its officers and directors to SEC approval, and regulating the investment company's capital structure.

The Investment Advisers Act of 1940. An investment adviser engages in the business of giving investment advice to others for compensation. This Act requires such persons to register with the SEC, prohibits fraud and deceptive practices, regulates aspects of their compensation, and specifies some related requirements intended to ensure fair dealing. In essence, it does for investment advisers on a lesser scale what the 1934 Act does for broker-dealers.

Administrative Procedure. The SEC is subject to the Administrative Procedure Act (“APA”). The APA establishes the standards for judicial review of SEC administrative decisions and specifies procedures to be followed when the SEC is engaged in rulemaking. Normally, the SEC will give advance notice of rule proposals and will afford interested parties an opportunity to comment. Typically, it acts at open meetings, and the discussions among the Commissioners or between them and their staff at these meetings can be candid, sharp, and often revealing.

However, the Commission does not act only through formal rulemaking. For example, it has never defined by rule what constitutes “insider trading,” and indeed it has resisted efforts aimed at legislative codification of this critical concept. Instead, it has made law on a case-by-case basis by pursuing an enforcement strategy. This “I-know-it-when-I-see-it” approach has been criticized on the grounds that it places a bureaucracy’s interest in maximizing its discretionary power ahead of the industry’s interest in bright-line standards and fair notice.\textsuperscript{182}

The Commission staff also has developed a unique system of lawmaking by responding to inquiries from the bar about how it interprets (or will enforce) various provisions of the federal securities laws. If the staff agrees with an interpretation proposed by an attorney with respect to a specific set of facts, it will state in its response that it will not recommend any enforcement action to the Commission if the attorney’s client proceeds along the lines indicated in the letter (and the factual statements in the letter are accurate and complete).\textsuperscript{183} These “no-action” letters are made publicly available by the Commission and afford an important source of guidance for the bar. However, no-action letters are not binding on the Commission, which from time to time does overrule the staff, usually prospectively, and takes a position inconsistent with the staff’s interpretation.\textsuperscript{184} Nor are they binding on private parties, who may still

\textsuperscript{182} The Commission has been sharply criticized by one former Commissioner precisely on this ground for relying excessively on litigation and enforcement proceedings to make law. See Roberta Karmel, Government by Prosecution (1981).

\textsuperscript{183} See Securities Act Rel. No. 4553 (Nov. 6, 1962).

\textsuperscript{184} See 17 C.F.R. § 202.1(d).
challenge a transaction or interpretation that the SEC’s staff has accepted. The staff may also change its views prospectively and cease to follow a position taken in an earlier no-action letter. In either case, controversy usually follows because practitioners understandably believe that the publication of no-action letters is intended to provide them with guidance which they cannot safely ignore but the Commission can. When, in 1991, the Commission reversed a long-standing staff no-action position, Commissioner Fleischman dissented sharply:

No matter how often the Commission repeats the mantra that no-action letters “only purport to represent the views of the officials who give them” or “set forth staff positions only” that “are not rulings of the Commission or its staff on questions of law or fact,” the Commission’s own contrary actions, not to speak of the contrary actions of the Commission’s staff, belie that message to the practicing securities bar.\(^\text{185}\)

Since the SEC first made no-action letters publicly available in 1971, they increasingly have come (as Commissioner Fleischman also noted) to state more general principles of law and to offer guidance relevant to persons beyond the immediate addressee.

On several occasions in the 1990s, controversy has arisen about the legal status of no-action letters. Repeatedly, courts have held that they are not judicially reviewable, finding that they amount to neither agency adjudication nor rule-making.\(^\text{186}\)

Criticism. Although the SEC has long enjoyed an enviable reputation with the public, the press and most of the bar, it has more recently come under increased criticism. Some academic critics have suggested that the SEC inefficiently and paternalistically over-regulates, placing investor protection on a special pedestal and never balancing it against other policy goals. Much of this criticism comes from “law and economics” scholars who subscribe to “public choice” theory.\(^\text{187}\) Public choice theory assumes that regulators do not simply pursue the public interest, but seek to maximize their own political support and accordingly favor the interests of powerful interest groups.\(^\text{188}\) From this per-


Another criticism is that there are a growing number of areas of law (e.g., the availability of statutory exemptions from registration) where the staff refuses to issue no-action letters. See D. Nagy, Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework, 83 Cornell L. Rev. 921 (1998).

\(^{186}\) See New York City Employees’ Retirement System v. SEC, 45 F.3d 7 (2d Cir. 1995) (SEC not required to follow notice and comment procedures of Administrative Procedure Act in issuing no-action letter that reverses long-established prior policy); Roosevelt v. E.I. Du Pont de Nemours & Co., 958 F.2d 416, 427 n. 19 (D.C.Cir. 1992) (no-action letter neither an adjudication nor rulemaking); Board of Trade of the City of Chicago v. SEC, 883 F.2d 525, 529–31 (7th Cir. 1989) (no-action letters not judicially reviewable because not orders of the Commission).

\(^{187}\) George Stigler, a Nobel Prize winning economist who taught at Columbia University and the University of Chicago, is usually seen as the father of this school.

spective, agencies typically are captured by "rent-seeking" interest groups, and regulation usually amounts to the allocation of subsidies to allies and the imposition of restraints on their competitors.

The bar has largely disdained this critique for another one. Practitioners frequently accuse the SEC of avoiding "bright-line" rules in favor of vague or subjective tests that maximize agency discretion. Professor Homer Kripke once argued that, in part because the SEC is dominated by attorneys, it has developed a regulatory "theology" that is part law and part lore but cannot be confidently understood by non-specialists. Its role, he suggests, is again to maximize the agency's discretion to do what it wants under the circumstances.

To note these criticisms is not to endorse them, but to suggest perspectives that may from time to time be applied to specific SEC decisions and policies that will be considered later in this casebook.

The Commodities Futures Trading Commission. Created by the Commodity Futures Trading Commission Act of 1972 (the "CFTC Act"), the CFTC was patterned closely after the SEC as an independent federal commission with five commissioners appointed by the President, with the advice and consent of the Senate, and serving similar five-year staggered terms. Prior to 1972, authority over futures trading had resided in the Department of Agriculture. The CFTC Act also authorized self-regulatory associations resembling the NASD and significant delegation of authority to SROs. Organizationally, the CFTC has three principal divisions: the Division of Clearing and Intermediary Oversight, the Division of Market Oversight, and the Division of Enforcement.

At the time of its creation in 1972, there was little overlap between the CFTC and the SEC, as futures trading related primarily to agricultural products. Thus, the CFTC was overseen by the Agriculture Committee of the House and Senate. Then, in 1975, the CFTC approved its first futures trading on financial assets (among other futures contracts initiated during that year, the Chicago Mercantile Exchange began to trade a futures contract on 90-day U.S. treasury bills). Trading in these contracts proved immensely popular because they enabled companies to hedge interest rate risk. Soon contracts also began to be traded in foreign currencies, allowing that risk also to be hedged. In time, commodity prices and many other risks could be hedged through futures, and the pace of financial innovation began to accelerate.

This expansion in the scope of futures trading beyond agricultural products and other commodities produced friction with the SEC. Potentially, anything traded as a future could be traded as an option (which is a security), and vice versa. In 1981, the SEC and the CFTC negotiated an agreement, known as the Shad-Johnson Accord, which allocated jurisdiction between them and precluded (at least for the next 20 years) trading in single-stock futures and narrow-based stock indexes (because the SEC feared that such products could be used to engage in insider trading that would be beyond the scope of the federal securities laws). 190


190. The prohibition on single-stock futures and narrow-based stock indexes was repealed by The Commodity Futures Modernization Act of 2000, which established a system of "coordinated regulation" between the SEC and the CFTC to prohibit insider trading through the medium of futures or swaps.