THE COMPETING PARADIGMS OF SECURITIES REGULATION

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ABSTRACT

Although the securities industry is primarily regulated by specific rules, it is also governed by general principles. When conduct violates a rule, the regulatory response is obvious—enforce the rule. The issue is more difficult when conduct does not violate a rule but violates a principle. A regulator can excuse the conduct on the ground that the law is unclear and prohibit the conduct going forward through rulemaking. Or, the regulator can punish the conduct through what I call a "principles-based" enforcement action. Since 2002, there has been a surge of principles-based enforcement actions, provoking criticism that regulators are engaging in "Regulation by Enforcement." This Article compares these regulatory tools and proposes criteria to guide regulators in choosing between them in communicating legal norms to the regulated.

These approaches represent two paradigms that must coexist but can also compete. Rulemaking reflects the mentality that securities regulation is a technical enterprise that should be left to experts who have created a comprehensive, efficient administrative scheme. Principles-based enforcement actions reflect the demand that regulators punish conduct that violates principles reflecting public values. For the most part, the regulated prefer a predictable regulatory regime, which rulemaking provides, whereas the public prefers

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decisive responses, which principles-based enforcement actions provide.

Based on these preferences, public choice theory would contend that regulators are more likely to address arguable misconduct by aggressively enforcing principles when public influence is high, while utilizing rulemaking when the regulated are influential. But this account is too simplistic—although the relative strength of interest groups can affect the incentives of regulators, their choices are subject to significant constraints. For example, a regulator cannot credibly bring a principles-based enforcement action without uncovering specific evidence of misconduct.

Even if regulators are so constrained, they should counter the perception that their choices are made to appease interest groups by considering the circumstances in which principles-based enforcement is appropriate. In doing so, regulators should take into account both the need for a predictable regulatory regime and the need to punish conduct that violates principles. They should consider: (1) whether the principle being enforced is well established or novel, (2) whether the application of the principle is consistent with existing rules, (3) whether there is compelling evidence establishing the misconduct, and (4) whether the conduct caused foreseeable public harm.

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INTRODUCTION

Since 2002, there have been an unprecedented number of innovative securities enforcement actions directed at areas arguably unregulated by rules. For their proponents, these actions have punished companies for conduct that violated fundamental principles. For their critics, these actions have been disruptive and circumvented a rulemaking system that gives companies notice and an opportunity to shape legal norms. These arguments reveal conflicting views about a regulatory system built on both rules and principles.[1] This Article analyzes these competing paradigms and how regulators choose between them in communicating legal norms to the regulated.[2] It offers a framework to guide the regulatory response to misconduct that does not clearly violate a rule.

For the most part, the securities industry is regulated by specific requirements set forth in rules. There is a rule requiring broker-dealer firms to maintain a certain amount of capital.[3] There are rules

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1. In the realm of securities regulation, the distinction between rules and principles has been discussed in terms of whether the regulatory scheme should shift from a rules-based system to a principles-based system. *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 8–9 (2006) [hereinafter INTERIM REPORT ON CAPITAL MARKETS REGULATION], *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (advocating a shift from prescriptive rules to broader principles); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 342–43 (2004) ("Sarbanes-Oxley ushers in and accelerates a major and probably inevitable transition, which will move us from a rules-based system of financial disclosure to a principles-based system."); Cristie Ford, *New Governance, Compliance, and Principles-Based Regulation*, 45 AM. BUS. L.J. (forthcoming 2008), *available at* http://ssrn.com/abstract=970130 (analyzing Canada's consideration of principles-based regulation). Lawrence Cunningham argues persuasively that no system is entirely rules-based or entirely principles-based. *See* Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation and Accounting*, 60 VAND. L. REV. (forthcoming Oct.–Nov. 2007).

The distinction between rules and principles is amorphous. Ronald Dworkin simply refers to "principles" as "the whole set of . . . standards other than rules . . . ." RONALD DWORKIN, TAKING RIGHTS SERIOUSLY 22 (1977). While this Article uses the rules/principles distinction, it does not attempt to precisely define it or take a position on whether a rules-based system is better than a principles-based system. Instead, its focus is on the regulatory tools of rulemaking and enforcement, which have distinguishable procedural characteristics.

2. Such decisions have been referred to as a "choice in policymaking form" by M. Elizabeth Magill in an article describing how courts give agencies such as the Securities and Exchange Commission (SEC) wide discretion in choosing between regulatory tools such as rulemaking, enforcement, and adjudication. *See* M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U. CHI. L. REV. 1383, 1437 (2004). Magill notes that little has been written about the way in which regulators choose between rulemaking and enforcement. *Id.* at 1442–43 ("There are few efforts to describe or explain how agencies choose among their available policymaking forms."); *see also* Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 6 (1998) (noting that administrative law theories "fail to incorporate any well developed vision of the administrative process—that is, of administrative law and administrative practice").

3. 17 C.F.R. § 240.15c3–1 (2007).

listing in exhaustive detail the facts a company must disclose when issuing securities.[4] There is a rule requiring investment advisers to register with securities regulators before advising clients.[5] There are rules prohibiting specific types of manipulation of securities offerings.[6] These rules are part of an extensive administrative scheme and were passed after a deliberative process in which industry was given notice of the proposed rule and an opportunity to comment.

Simultaneously, the securities industry is governed by broad principles largely set forth in statutes and the common law.[7] Fraud, an open-ended concept, has long been prohibited.[8] Broker-dealers are required to conform to high standards of commercial trade and honor.[9] Investment advisers are required to act as fiduciaries with respect to their customers.[10] Principles are largely defined through an adversarial enforcement process that can be more rapid than rulemaking but can also cause significant disruption.

When conduct violates a rule, the regulatory response is clear—enforce the rule. But what if a securities regulator uncovers misconduct that was previously unregulated or arguably does not violate a particular rule, what I will refer to as "arguable

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4. *Id.* pts. 210, 228.

5. *Id.* § 240.15.

6. *Id.* §§ 242.100–.105.

7. Because rules themselves can set forth principles, I distinguish rules reflecting general principles from rules that make specific prescriptions, which have been referred to as "prescriptive rules." *See* INTERIM REPORT ON CAPITAL MARKETS REGULATION, *supra* note 1, at 8; MCKINSEY & CO., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL LEADERSHIP 3–5, 95–129, *available at* http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf. I include rules reflecting principles in the category of "principles." When I refer to "rules" I am referring only to "prescriptive rules."

8. 17 C.F.R. § 240.10b-5 (prohibiting certain deceptive devices); *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) (noting that legislative history described section 10(b) as a "catchall" clause enabling the SEC "to deal with new manipulative (or cunning) devices." (internal quotations omitted)); The Martin Act, N.Y. GEN. BUS. LAW § 352 et seq. (McKinney 2006).

9. Nat'l Ass'n of Sec. Dealers, NASD Manual, Rules of the Association, Rule 2110, http://finra.complinet.com/finra/index.html (last visited Oct. 12, 2007).

10. Investment Company Act of 1940 § 36(a), 15 U.S.C. § 80a-35 (2000); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."); EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 11 (2005) (discussing the common-law fiduciary duty).

misconduct"?[11] The target asserts it did not have adequate notice that its conduct was wrong in relation to existing rules. But there is a case that the conduct violates a broader principle. Should the regulator respond by excusing the conduct but subsequently making it clear that the conduct is prohibited through rulemaking? Or should the regulator punish the conduct and enforce the broader principle through what I call a "principles-based enforcement action"?[12]

This is not just a theoretical choice. When responding to pervasive conflicts of interest caused by the close relationship between equity research and investment banking, the Securities and Exchange Commission (SEC) initially responded by proposing new rules to regulate that relationship.[13] The New York Attorney General chose to pursue an investigation, resulting in a principles-based enforcement action, significant penalties, and structural reform.[14]

In a number of other areas, securities regulators[15] have dramatically shifted in their response to arguable misconduct, acting through principles-based enforcement actions rather than rulemaking.[16] This new pattern reverses the prior regulatory

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11. There are obviously different degrees of "arguable misconduct," and I do not attempt to precisely define the term.

12. In contrast, straightforward enforcement of a rule can be called a "rules-based enforcement action."

13. *See* Charles Gasperino & Michael Schroeder, *Pitt and Spitzer Butted Heads to Overhaul Wall Street Research*, WALL ST. J., Oct. 31, 2002, at A1 ("The SEC chairman believed that the solution to the problem was developing a new set of standards for analysts, while at the same time directing self-regulatory organizations, such as the National Association of Securities Dealers and the New York Stock Exchange, to examine conflicts of interest and draw up new rules on analyst compensation and disclosure practices.").

14. *See id*. Of these three results, this Article focuses on the initial decision to punish arguable misconduct with a principles-based enforcement action. I leave analysis of the imposition of penalties and structural reforms resulting from such actions for another day.

15. In this Article, when I refer to "securities regulators," I include not only the Securities and Exchange Commission (SEC) but also state securities regulators such as the New York Attorney General as well as self-regulatory organizations such as the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE). Of course, there are differences in the ways that state regulators and the SEC regulate. For example, only the SEC can pass nationwide rules. Although state regulators cannot pass such rules, they have the choice of deferring to SEC rulemaking rather than bringing a principles-based enforcement action. For the sake of simplicity, I refer to these actors collectively and leave the implications of the trend toward increased state involvement in securities regulation for another day.

16. *See, e.g.*, Complaint, New York v. Canary Capital Partners, LLC (N.Y. Sup. Ct. Sept. 3, 2003) (undocketed) [hereinafter Canary Complaint], *available at* http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf; Complaint, SEC v. Credit Suisse First Boston Corp., No. 02-90 (D.D.C. Jan. 22, 2002) [hereinafter CSFB Complaint]; Affidavit of Eric R. Dinallo in Support of Application for an Order Pursuant to General Business Law Section 354, *In re*

approach, which saw rulemaking as the primary source of legal norms that comes necessarily before enforcement actions.[17] For example, in the late 1990s, regulators responded to reports that companies were selectively disclosing material nonpublic information to favored research analysts by passing a rule making it clear that the conduct was wrong rather than by punishing the conduct through enforcement actions.[18]

Skeptics have attacked these principles-based actions as "Regulation by Enforcement,"[19] a phrase criticizing the tendency of

Spitzer v. Merrill Lynch & Co., No. 02-401522 (N.Y. Sup. Ct. Apr. 8, 2002) [hereinafter Dinallo Aff.]; Stephen M. Cutler, Dir., Div. of Enforcement, SEC, Speech to the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute, Chi, Ill. (Apr. 29, 2004), *available at* http://www.sec.gov/news/speech/spch042904smc.htm ("[A]ll but three of the 12 penalties of $50 million or more obtained in Commission settlements since 1986 were obtained in the last twelve months.").

17. This emphasis on rulemaking was part of a general trend among administrative agencies. *See* Magill, *supra* note 2, at 1398 ("[B]y the mid-1970s, rulemaking was the primary and preferred mode of making policy for many agencies."). The shift by securities regulators to principles-based enforcement actions may be part of a more general trend toward using litigation as a policymaking tool. *Id.* ("Some [scholars] point to the rise of agency litigation as a strategy for achieving regulatory objectives.").

18. *See* 17 C.F.R. §§ 243.100–.103 (2007).

19. *See, e.g.*, INTERIM REPORT ON CAPITAL MARKETS REGULATION, *supra* note 1, at 9 ("Enforcement actions in recent years have been used as a basis for *ad hoc* rule-writing."); Jonathan R. Macey, *Who is Protecting the Investor?: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117, 128 n.36 (2004) ("Rulemaking by enforcement refers to the presumptively illegitimate process by which regulators proceed with rulemaking 'ex post,' i.e. after certain conduct occurs, rather than through more legitimate formal notice-and-rulemaking procedures."); Daniel Dunaief, *SEC to Set Tough Analyst Rules*, DAILY NEWS (N.Y.), Apr. 10, 2003, at 68 ("There are a lot of smart people who haven't been consulted . . . [t]his is regulation by enforcement." (quoting Saul Cohen, partner at the firm Proskauer Rose)); Michael G. Oxley, *Letter to the Editor, Who Should Police the Financial Markets?*, N.Y. TIMES, June 9, 2002, at B11 ("In this time of lagging investor confidence, policymaking through litigation discussed in a closed conference room is not healthy for the U.S. capital markets, and not good for investors."); Tom Petruno, *SEC, Fund Firm May Face Off*, L.A. TIMES, Dec. 11, 2005, at C1 ("A key question is whether the Republican majority on the commission would consider a solid case, or an example of what some SEC critics label 'regulation by enforcement'—rewriting industry rules by suing a particular party instead of simply ordering changes for all players."); Stephen M. Cutler, Dir., Div. of Enforcement, SEC, Remarks at the F. Hodge O'Neal Corporate and Securities Law Symposium (Feb. 21, 2003), *available at* http://www.sec.gov/news/speech/spch022103smc.htm ("As an enforcement lawyer, I am quite familiar with the complaint raised by defendants or respondents, and even by an occasional SEC Commissioner, that a proposed settlement amounts to rulemaking by enforcement."); Karen Donovan, *Under Siege*, REGISTERED REP., Sept. 1, 2005, http://registeredrep.com/regulatory/finance_siege/ ("The defense bar alleges that regulators are now making up rules as they go along, a phenomenon

securities regulators to establish norms ex post through enforcement actions rather than ex ante through rulemaking.[20] The "Regulation by Enforcement" critique notes that enforcement actions can cause significant economic disruption. Industry may be unfairly surprised when regulators advance broad principles in novel ways through enforcement. Also, by developing regulatory norms through enforcement, regulators sidestep the extensive administrative scheme comprised of rules constructed through expert input and deliberation.

For the most part, the regulated prefer the rulemaking process because it is more predictable and can be influenced. Rulemaking is premised on the assumption that experts should construct cost-effective norms in collaboration with industry, reflecting what I call an administrative paradigm. On the other hand, the public prefers principles-based enforcement actions because they are decisive. Principles-based enforcement actions offer a more confrontational approach directed at conduct that violates societal values, reflecting what I call the public values paradigm. Although these two paradigms must coexist, there are times when they compete.

Given these preferences, public choice theory predicts that regulators will be more likely to respond to arguable misconduct with rulemaking when the influence of the regulated is high and more likely to respond with principles-based enforcement when public influence is high. Over time, there may be a feedback effect that results in regulatory cycles. A period in which a more passive

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they call 'regulation by enforcement.' The enforcement cases keep coming, even as the SEC proposes rules to broaden and clarify duties that it says [broker-dealers] have been violating.").

The role of litigation in establishing norms has been an issue in other areas such as environmental regulation. *E.g.*, Andrew P. Morriss, Bruce Yandle & Andrew Dorchak, *Choosing How to Regulate*, 29 HARV. ENVTL. L. REV. 179, 248–50 (2005) (analyzing when agencies such as the EPA decide whether to use rulemaking versus litigation to promulgate norms). *See generally* REGULATION THROUGH LITIGATION (W. Kip Vicusi ed., 2002) (analyzing the formation of norms in tobacco regulation, firearms, lead-based paint hazards, breast implants, malpractice and legal reform); Thomas O. McGarity, Douglas Kysar & Karen Sokol, *The Truth about Torts: Lawyers, Guns, and Money*, CENTER FOR PROGRESSIVE REFORM PUBLICATION, July 2006, at 3 (criticizing regulation by litigation trope); Robert B. Reich, *Regulation Is Out, Litigation Is In*, THE AMERICAN PROSPECT ONLINE, Feb. 11, 1999, http://www.prospect.org/cs/articles?article=regulation_is_out_litigation_is_in (discussing tobacco and handgun litigations and observing: "The era of big government may be over, but the era of regulation through litigation has just begun.").

20. *See* ROBERTA KARMEL, REGULATION BY PROSECUTION (1982) (first setting forth the "Regulation by Enforcement" critique). A later article coined the phrase "Regulation by Enforcement." *See* Harvey L. Pitt & Karen L. Shapiro, S*ecurities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 149 (1990).

rulemaking approach dominates may lead to regulatory gaps, aggressive conduct that harms the public, and public outrage. On the other hand, a period of aggressive principles-based enforcement actions may lead to the exhaustion of cases in which there is evidence of specific wrongdoing, criticisms of regulatory overreaching, and mobilization by the regulated.

But the public choice account, which implies that regulatory choices are essentially efforts to appease different interests, is incomplete. Regulators are constrained in their choice between rulemaking and principles-based enforcement by the nature of the facts they uncover. To the extent that allegations of misconduct are generalized and theoretical, rulemaking may be a more appropriate initial response because there may be no basis for a principles-based enforcement action. In contrast, when there is specific evidence of serious misconduct, it is difficult for regulators to ignore such evidence to appease industry. Of course, regulators may have greater incentives and ability to initiate aggressive investigations when there is public pressure, but their decision to act is not solely based on meeting the preferences of interest groups.

Even if they are so constrained, regulators should be aware of the public choice critique and counter it by considering certain criteria to guide their choice between rulemaking and principles-based enforcement. In doing so, they should consider the regulatory needs for predictability and the punishment of conduct that violates principles. This Article offers a framework that considers the concerns raised by the administrative and public values paradigms and guides regulators in choosing between rulemaking and principles-based enforcement actions in communicating legal norms to the regulated.

In determining whether to respond to arguable misconduct with a principles-based enforcement action rather than rulemaking, regulators should consider: (1) whether the applicable principle is novel or well defined; (2) whether the application of the principle is consistent with existing rules; (3) whether there is compelling evidence of misconduct; and (4) whether the misconduct caused significant, foreseeable public harm.

I illustrate the application of these factors to five ways in which conduct interacts with rules and principles: (1) conduct violates a principle set forth in a rule; (2) conduct violates both a rule and a principle; (3) conduct is in an area that is unregulated by rules, does not violate a rule, but violates a principle; (4) conduct is in an area that is heavily regulated by rules, does not violate a rule, but violates a principle; and (5) conduct is sanctioned by a rule but violates a principle. Regulators should be most inclined to use principles-based enforcement actions in scenario (1) and least inclined to use principles-based enforcement actions in scenario (5).

In Part I, I describe how for a period during the 1990s, rulemaking was the likely response to arguable misconduct. I discuss the "Regulation by Enforcement" critique to illustrate the distinction between rulemaking and principles-based enforcement actions as regulatory tools. I illustrate the influence of the "Regulation by Enforcement" critique through the case of Regulation FD (Fair Disclosure), in which the SEC chose a rulemaking rather than a principles-based enforcement response to arguable misconduct.

In Part II, I describe the resurgence of principles-based enforcement actions that began in 2002. In three major areas, government regulators responded to arguable misconduct through aggressive principles-based enforcement actions.

In Part III, I argue that the regulated generally prefer rulemaking and the public generally prefers principles-based enforcement actions. The rulemaking and principles-based enforcement approaches respectively represent two distinct regulatory paradigms, an administrative and a public values paradigm, reflecting different views about the process of generating legal norms as well as their substance.

In Part IV, I analyze how regulators choose between rulemaking and principles-based enforcement actions. Public choice theory would predict that the choice is largely determined by the relative influence of the public and of the regulated. These influences can shift over time, causing regulatory cycles. I argue that this account is incomplete and that regulators are more constrained in their choice of regulatory response than an uncritical application of public choice theory would predict. I offer a framework to guide regulators in deciding how to choose between rulemaking and principles-based enforcement actions in communicating legal norms to the regulated.

I. THE REIGN OF RULEMAKING

The main advantage of a rules-based regulatory regime is its predictability. The regulated can make decisions without worrying that their actions will be second-guessed by regulators. When regulators develop norms through enforcement actions, they insert uncertainty into the system. This basic idea was set forth forcefully by the influential "Regulation by Enforcement" critique.

A. The "Regulation by Enforcement" Critique

The first form of the critique was set forth in a 1982 book by former SEC Commissioner Roberta Karmel, *Regulation by Prosecution*.[21] In that book, Karmel criticized the tendency of the SEC to make policy through enforcement actions rather than through rulemaking. As a result, she argued, the SEC was unnecessarily antagonistic toward business and pursued cases that were only tenuously related to securities regulation. She gave examples such as enforcement actions in the 1970s against companies for paying bribes in foreign countries in which the SEC tried to expand its jurisdiction to areas tangentially related to the securities laws.[22]

Harvey Pitt, a leading securities law practitioner who later became SEC Chairman, advanced the next variation of the critique. In the 1990 article *Regulation by Enforcement*, Pitt and his coauthor, Karen Shapiro, used the phrase to criticize the SEC's efforts against insider trading. Pitt and Shapiro defined "Regulation by Enforcement" as the SEC's practice of using "enforcement proceedings to develop new legal theories and remedies."[23] As Karmel had observed earlier,[24] Pitt and Shapiro noted that

> [t]he SEC has, at times, resorted to ad hoc enforcement of the federal securities laws in particular contexts, in the absence of meaningful advance guidance (or warning) to those subject to the agency's jurisdiction, in large measure because of the agency's

21. KARMEL, *supra* note 20.

22. *Id.* at 146–59.

23. Pitt & Shapiro, *supra* note 20, at 155 (emphasis omitted). An article in the environmental law context refers to the strategy as "Regulation-by-litigation," where

> [r]ather than issue a proposed rule or invite affected parties to negotiate, an agency sues one or more regulated entities, charging them with violation of an existing statute, regulation or common law rule. The lawsuit is often based on a novel interpretation of the statute or regulation and may concern behavior that the regulated entities believe the agency has accepted in the past. Using the threat of substantial liability for the alleged breach, the agency then persuades or coerces the regulated entity to agree to a consent decree or injunctive relief that includes imposition of substantive regulatory provisions.

Morriss, Yandle & Dorchak, *supra* note 19, at 203.

24. KARMEL, *supra* note 20, at 95–98.

> institutional fear that any specific regulations it might promulgate could prove underinclusive or susceptible of easy evasion.[25]

Pitt and Shapiro characterized the SEC's efforts against insider trading as "Regulation by Enforcement."[26] Insider trading was and still is an offense for which the SEC and Congress have not precisely defined the applicable legal norm.[27] Instead, the body of law governing insider trading was created in an ad hoc way through enforcement actions pursued by SEC staff and approved by lower courts.[28] As a result, Pitt and Shapiro argued, individuals do not have clear notice as to what conduct qualifies as insider trading.[29]

According to Pitt and Shapiro, securities regulators are inclined to proceed by enforcement actions because it is easier to bring an action retrospectively against specific acts than prospectively craft rules relating to a wide array of conduct. But "Regulation by Enforcement" raises concerns in that "notions of due process require ample, advance notification of precisely what types of conduct will be prohibited, before any person may be civilly or criminally prosecuted for a violation of those standards."[30]

The "Regulation by Enforcement" critique held up rulemaking as the ideal generator of norms governing the securities industry, explaining:

> [R]egulations prescribe, in advance of their application, normative standards of conduct to which persons subject to agency jurisdiction must adhere in the future. Enforcement powers apply existing rules to past facts, to assure compliance with regulatory standards, both by the entity subject to the standard (but accused of noncompliance) and by other entities similarly situated. In a proper context, an administrative agency should define normative standards first, offer interpretive guidance second (to the extent feasible), and compel obedience to those standards as a last resort, when it is clear that those standards have been well publicized and comprehended, but disregarded.[31]

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25. Pitt & Shapiro, *supra* note 20, at 156.
26. *See id.* at 199–200.
27. *See id.* at 206–08 (analyzing the pitfalls of possible definitions). While making this observation, Pitt and Shapiro do not propose a definition.
28. *See id.* at 207–08.
29. *Id.* at 207.
30. *Id.* at 167 (emphasis omitted).
31. *Id.*

The "Regulation by Enforcement" critique reflects a general sense that norms are best initiated by rulemaking whereas enforcement actions should merely enact previously defined rules.

There is evidence that the critique influenced SEC policy. After the early form of the critique, in the 1980s, the SEC shifted from prosecuting companies to focusing on insider trading, which involves wrongdoing by individuals rather than companies.[32] This effort against insider trading in turn provoked Pitt and Shapiro's "Regulation by Enforcement" critique, which was influential in the 1990s. A 2005 study observes that prior to 2002, SEC enforcement actions tended to target companies with smaller market capitalization than did private plaintiffs.[33] Even when it was given new statutory powers to seek civil monetary penalties in 1990,[34] the SEC used the power sparingly over the next decade against public companies.[35] This tendency might

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32. *See id.* at 199–201 (describing insider trading as the "Centerpiece of the Enforcement Program of the 1980s" and observing that "[i]nsider trading cases provided a ready vehicle for pursuing individuals rather than issuers, since it was thought that, only in the rare case, if at all, would a company play a role in insider trading other than as the source or object of the information in question").

That is not to say that the SEC was not bringing enforcement actions during this period. Indeed, the SEC's action against the NASD in 1996 for anticompetitive practices was a major principles-based enforcement action. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 698–701 (3d ed. 2003). But it appears that for the most part, the focus was on areas directed at individuals or smaller firms such as "microcap or penny stock fraud and day trading abuses as well as traditional areas such as unregistered securities, financial fraud, and insider trading." *Id.* at 638 (footnote omitted).

33. *See* James D. Cox & Randall S. Thomas, *Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?*, 80 NOTRE DAME L. REV. 893, 897–98 (2005). Post-2002, the study shows that the SEC has begun targeting much larger companies. *Id.* at 901–02.

34. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified in scattered sections of 15 U.S.C.). Prior to this statute, the impact of enforcement actions was also limited by the remedies regulators had at their disposal. *See, e.g.*, Pitt & Shapiro, *supra* note 20, at 295 ("Under the Commission's old enforcement program, which emphasized injunctive relief, and permitted defendants to walk away from litigation by promising to do what the law already required those defendants to do (namely, to obey the law), without any acknowledgment of wrongdoing, the prospects of settlement were quite high."); *see also* Cutler, *supra* note 16 ("[U]ntil very recently, the Commission necessarily relied almost exclusively on forward-looking relief, such as federal court injunctions, orders of disgorgement, and remedial undertakings such as procedural reforms and independent monitors, to enforce compliance with securities laws.").

35. *See* Richard A. Spehr & Michelle J. Annunziata, *The Remedies Act Turns Fifteen: What Is Its Relevance Today?*, 1 N.Y.U. J. L. & BUS. 587, 596–97 (2005) ("It has been observed that in the decade or so following the enactment of the Remedies Act, the SEC did not often seek or obtain penalties against public companies."); *see also* John C. Coffee, Jr., *Understanding Enron:*

indicate that the SEC was focusing on unsophisticated individuals and smaller companies with problems complying with basic rules because they did not have the legal resources and reputational capital of larger companies.

B. The Case of Regulation FD

The influence of the "Regulation by Enforcement" critique is illustrated by the passage of Regulation FD (Fair Disclosure). In the late 1990s the SEC discovered that "many issuers [we]re disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public."[36] Such selective disclosure resulted in profitable trading on the information before it was released to the broader market.

Selective disclosure was only arguably misconduct because although it implicates similar concerns as insider trading in that favored individuals were able to profit solely by virtue of their position, it was not entirely clear that it constituted insider trading under existing doctrine. Under a 1983 Supreme Court case, *Dirks v. SEC*,[37] for insider trading liability to attach, the tipper (who disseminates the information) needs to breach a fiduciary duty, or obtain some kind of personal benefit or gain.[38] A company, who is the tipper in this situation, does not gain in the same way as the paradigmatic corporate insider who reveals insider information in exchange for money or a share of the profits. A company, however, arguably gains from the selective disclosure of information because it strengthens relationships with analysts or investors who shape the public perception of the company.

The SEC could have responded to the evidence of selective disclosure by bringing enforcement actions against the most egregious examples of such conduct and arguing for an extension of insider

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"It's About the Gatekeepers, Stupid," 57 BUS. LAW. 1403, 1409–10 & n.33 (2002) (noting that the SEC pursued individuals rather than the Big Five accounting firms during the 1990s); Cox & Thomas, *supra* note 33, at 897–98 (discussing the SEC's tactics in using its expanded statutory powers).

36. Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000) (codified at 17 C.F.R. pts. 240, 243, 249).

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

38. *Id.* at 661–62.

trading doctrine. Instead, it chose to address the problem through a process similar to that advanced by the proponents of the "Regulation by Enforcement" critique. It proposed and promulgated a rule prohibiting companies from intentionally disclosing nonpublic information to a select group of insiders without releasing it at the same time to the general public.[39] SEC staff then made an effort to publicize the types of conduct it would be targeting.[40]

In doing so, the SEC was clear that the "Regulation by Enforcement" critique was a factor in choosing a rulemaking approach. In the final rule release, it explained:

> Some commenters contended that rulemaking on this topic was an inappropriately broad response to the issue. They suggested instead that we use existing tools (namely, the law of insider trading) to bring individual enforcement actions in those cases that appear to involve significant selective disclosures. While we have considered this approach . . . we do not agree that this is the appropriate response to the legal uncertainties posed by current insider trading law. In other contexts, we have been criticized for attempting to "make new law" in an uncertain area by means of enforcement action and urged instead to seek to change the law through notice-and-comment rulemaking. We believe that this rulemaking is the more careful and considered response to the problem presented by selective disclosure.[41]

The "Regulation by Enforcement" critique led the SEC to address the problem of selective disclosure through a new rule rather than enforcement actions. Thus, by the end of the 1990s, the "Regulation by Enforcement" critique had some influence.

C. Rulemaking vs. Principles-Based Enforcement

The "Regulation by Enforcement" critique implicitly assumes that rulemaking is more legitimate than enforcement and should

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39. 17 C.F.R. §§ 243.100–.103 (2007).

40. Richard H. Walker, Dir., Div. of Enforcement, SEC: Regulation FD—An Enforcement Perspective (Nov. 1, 2000), *available at* http://www.sec.gov/news/speech/spch415.htm.

41. Selective Disclosure and Insider Trading, 65 Fed. Reg. at 51,718 (citations omitted). In a lecture panel presentation discussing Regulation FD, Harvey Goldschmid, who was General Counsel of the SEC when Regulation FD was first presented, noted that he believed that the SEC could have won an extension of *Dirks* so the insider trading laws would apply to issuers, but that litigation might have imposed too many costs and would have caused a chilling effect on corporate communications. Lecture: Panel Discussion: The SEC's Regulation FD (Feb. 12, 2001), *in* 6 FORDHAM J. CORP. & FIN. L. 273, 279–81 (2001).

necessarily precede it. In other words, enforcement should be limited to rules-based enforcement. But why is that necessarily so? The securities industry is governed not only by specific rules directed at specific conduct but general principles embodied in statutes and case law that are potentially applicable to a wide array of behavior.[42] Discussion of enforcement must also include principles-based enforcement.

The law has long recognized the difference between rules, which are promulgated ex ante, and principles, which are defined ex post.[43] The distinction between rules and principles inherent in the securities regulatory regime was recognized as early as 1947 by the United States Supreme Court in its seminal administrative law decision, *SEC v. Chenery Corp*.[44] In that case, the Supreme Court reviewed an SEC order relating to the reorganization of a public utility holding company. The SEC had taken the position that officers and directors of the company could not purchase preferred stock in the company during its reorganization to maintain management's control. The SEC "felt that the officers and directors of a holding company in process of reorganization under the Act were fiduciaries and were under a duty not to trade in the securities of that company during the reorganization period."[45] The SEC's original basis for its conclusion was that court cases imposed such a duty. But the Supreme Court disagreed, finding that neither the courts nor the SEC itself had imposed such a rule, and remanded the case.[46]

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42. An example of a principle is the general prohibition against "manipulative or deceptive devices" and fraud set forth in section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. These provisions are intentionally broad and were described as "a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.'" Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) (quoting a statement of Thomas Corcoran in a hearing before the House Committee on Interstate and Foreign Commerce).

43. The law review literature often refers to the distinction between rules and standards. *See, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559 (1992) ("Arguments about and definitions of rules and standards commonly emphasize the distinction between whether the law is given content *ex ante* or *ex post*."); Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953, 961 (1995) ("[W]e have a rule, or rule-ness, to the extent that decisions about cases have been made *ex ante* rather than *ex post*."). When I use the word principles, I am essentially referring to standards. I use the word principles because much of the literature specific to the securities regulation refers to a distinction between rules and principles rather than rules and standards. *See supra* note 1.

44. SEC v. Chenery Corp., 332 U.S. 194 (1947).

45. *Id.* at 197.

46. *Id.* at 198.

On remand, the SEC issued a new order, coming to the same result but articulating a new reason, "that the proposed transaction is inconsistent with the standards of sections 7 and 11 of the [Public Utility Holding Company] Act."[47] In other words, the transaction violated a principle embodied in a statute. On appeal, management argued that the SEC did not have the power to apply what was essentially a new principle retroactively. They claimed that "the Commission would be free only to promulgate a general rule outlawing such profits in future utility reorganizations; but such a rule would have to be prospective in nature and have no retroactive effect upon the instant situation."[48]

The Supreme Court rejected this argument. It reasoned that although the SEC had the power to proceed by rulemaking, and should do so in most instances, to accept the management's position would "stultify the administrative process."[49] It established that the SEC could implement legal norms not only through the rulemaking process, but also through principles-based enforcement, explaining:

> Not every principle essential to the effective administration of a statute can or should be cast immediately into the mold of a general rule. Some principles must await their own development, while others must be adjusted to meet particular, unforeseeable situations. . . . [A]n administrative agency must be equipped to act either by general rule or by individual order.[50]

The *Chenery* Court observed that the choice of policymaking form was not dictated by any legal standard, but was largely within the discretion of the administrative agency.[51] Although *Chenery* involved an agency adjudication, its reasoning that the SEC has wide discretion in the way it chooses to communicate legal norms applies equally to enforcement actions.

Thus, there are two possible regulatory responses to arguable misconduct—rulemaking and principles-based enforcement. Part II tells the story of the reemergence of the latter approach.

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47. *Id.* at 199.

48. *Id.* at 199–200.

49. *Id.* at 202.

50. *Id.*

51. *Id.* at 203 ("[T]he choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency.").

II. THE RESURGENCE OF PRINCIPLES-BASED ENFORCEMENT

Just a few years after Regulation FD was passed, the securities industry faced major enforcement actions in three areas: (1) kickbacks in the Initial Public Offering (IPO) allocation process, (2) conflicts of interests affecting Wall Street research analysts, and (3) mutual funds that profited from market timing arrangements.[52] All three involved examples of what I describe as arguable misconduct, instances in which the conduct was largely unregulated by rules but violated a broader principle. The prior ideal, in which rulemaking

52. *See* Cristie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757, 766 (2005) ("The [SEC] Enforcement Division has filed an unprecedented number of actions, especially against organizations, in the last two years."). In addition, the enforcement response to the corporate scandals that erupted in the early part of this century has included criminal prosecutions, private class actions, and civil regulatory enforcement actions. Prosecutors have won criminal convictions against high level executives of bankrupt companies who committed accounting fraud. *See, e.g.*, John R. Emshwiller et al., *Symbol of an Era: Lay, Skilling are Convicted of Fraud—Jurors Reject Defense Claim That Enron Was Clean; Question of Credibility—Two 'Very Controlling People,'* WALL ST. J., May 26, 2006, at A1; Barry Meier, *2 Guilty in Fraud at a Cable Giant*, N.Y. TIMES, July 9, 2004, at A1; Dionne Searcey et al., *Ebbers is Sentenced to 25 Years for $11 Billion WorldCom Fraud*, WALL ST. J., July 14, 2005 at A1. Class action plaintiffs have brought numerous suits and negotiated billions of dollars in settlements against the gatekeepers who should have detected such fraud. *See, e.g.*, Robin Sidel, *J.P. Morgan to Pay $2 Billion As Street's Bill for Bubble Soars*, WALL ST. J., Mar. 17, 2005, at A1; Randall Smith & Robin Sidel, *J.P. Morgan Agrees To Settle IPO Case for $425 Million*, WALL ST. J., Apr. 21, 2006, at C4; Jonathan Weil & Robin Sidel, *WorldCom Investors Settle Lawsuits—Investment Banks Will Pay Almost All of $651 Million in Pact Tied to Bond Deals*, WALL ST. J., Oct. 27, 2005, at A3.

While all three responses have had success, I would argue that civil regulatory enforcement actions have been the most instrumental in communicating legal norms to industry. Criminal law is limited by its stringent burden of proof and the collateral effects of corporate indictments. *See, e.g.*, Ken Brown et al., *Called to Account: Indictment of Andersen in Shredding Case Puts Its Future in Question—Obstruction of Justice Count May Speed the Departure of Clients and Partners—Firm Calls It 'Death Penalty,'* WALL ST. J., Mar. 15, 2002, at A1. Private class actions focus on private interests and terms of settlements are often classified. *See, e.g.*, Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963, 1000 (1994) ("Although private claims play an undeniably important role in the enforcement of the securities laws, they are brought for entirely private ends. Private damages actions focus narrowly on how much the individual lost as a result of the illegal conduct and whether that injury can be reasonably quantified." (quoting SEC v. Rind, 991 F.2d 1486, 1490 (9th Cir. 1993))). Because of their civil nature, enforcement actions do not suffer from the restrictions of criminal prosecutions. Because they are brought by government officials serving the public interest, they do not suffer from the same limits as private class actions. Through the use of subpoena power, the government can obtain evidence and craft complaints that are based on more than conjecture. The allegations can be widely publicized so that the precise evidence of wrongdoing and why it was wrong is communicated to the public. By doing so, the application of the legal norm can be communicated to industry with great speed.

preceded rules-based enforcement actions, was reversed in all three cases, in which principles-based enforcement actions preceded rulemaking.

A. The IPO Cases

The first example is the action by the SEC and NASD against Credit Suisse First Boston (CSFB) for abuses related to its allocation of IPO shares to brokerage customers.[53] CSFB entered into *quid pro quo* arrangements with its customers where: (1) CSFB would provide a customer with shares in an IPO likely to immediately increase exponentially in price; and (2) the customer would funnel back a portion of its abnormally high IPO profits to CSFB by paying abnormally high rates for executing unrelated securities transactions.[54]

1. *The Market for "Hot IPOs."* In an IPO, a company issues shares to the public for the first time.[55] Typically, an investment bank will underwrite the deal, purchasing the shares from the issuer at a discount (usually 7 percent) and reselling the shares to the public.[56] The underwriter advises the issuer regarding marketing the IPO to investors and setting the initial price at which the IPO shares will be sold.[57] Many underwriters have brokerage divisions that execute

53. CSFB Complaint, *supra* note 16, at paras. 1–2; *see also* SEC Sues CSFB for IPO Violations; CSFB Will Pay $100 Million, SEC Litigation Release No. 17327 (Jan. 22, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17327.htm (discussing abuses relating to the allocation of IPO shares to brokerage customers).

54. CSFB Complaint, *supra* note 16, at paras. 1–2.

55. *Id.* at para. 8.

56. *See In re* Initial Pub. Offering Sec. Litig., 241 F. Supp. 2d 281, 293–94 (S.D.N.Y. 2003); Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583, 590–92 (2004).

Typically, there is more than one investment bank involved in the deal. Most IPOs are "offered to the public through an 'underwriting syndicate,' a group of underwriters who agree to purchase the shares from the issuer and then sell the shares to investors." SEC, Initial Public Offerings: Why Individuals Have Difficulty Getting Shares, Nov. 24, 1999, http://www.sec.gov/answers/ipodiff.htm [hereinafter SEC, Initial Public Offerings]; *see also* Billing v. Credit Suisse First Boston Ltd., 426 F.3d 130, 137–38 (2d Cir. 2005) (noting the risk management function of forming underwriting syndicates as well as syndicates' prominence), *rev'd on other grounds*, 127 S. Ct. 2383 (2007) .

57. *See generally* NYSE/NASD IPO ADVISORY COMM., REPORT AND RECOMMENDATIONS 4–5 (2003) ("We encourage underwriters to engage in an open discussion with the issuer's pricing committee, explaining to the issuer the context and significance of indications of interest from various investors, as well as sharing their perspective on this demand.").

equity transactions through which they can allocate the IPO shares.[58] Investors who receive allocations of IPO shares have the right to purchase the IPO shares at the initial offering price.

When the demand for shares of an issuer is significantly greater than the supply, investors may be willing to pay substantially more for an IPO share than its initial price.[59] Thus, the price of these shares can quickly rise.[60] Investors who receive IPO allocations and purchase the stock at the initial offering price can make a substantial profit by immediately selling those shares in the secondary market.[61] IPOs that immediately trade at a premium in the secondary market are known as "hot IPOs."[62] The late 1990s saw one of the most fervent "hot IPO" markets, especially with respect to IPOs by internet companies.[63]

Investment banks allocate the bulk of IPO shares to large institutional clients such as mutual funds and hedge funds.[64] Retail customers such as smaller institutions and individual investors find it more difficult to receive allocations because the main criteria for allocating IPO shares to investors is the amount of business the

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58. *See* CSFB Complaint, *supra* note 16, at para. 11.

59. Studies show that this commonly occurs. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 300 ("For at least five decades, studies have shown that IPOs generally trade on the open market at a price significantly higher than the offering price, a phenomenon known as underpricing.").

60. John C. Coffee, Jr., *The IPO Investigations: Who's the Victim? What's the Harm?*, http://www.pbs.org/wgbh/pages/frontline/shows/dotcon/crying/coffeeipos.html (last visited Nov. 27, 2007) ("[P]rice spikes occur because the offering is oversubscribed—that is, the underwriters have solicited 'indications of interest' from potential buyers amounting to many times the number of shares that the issuer . . . wishes to sell.").

61. *See In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 294; CSFB Complaint, *supra* note 16, at para. 17.

62. *See* Billing v. Credit Suisse First Boston Ltd., 426 F.3d 130, 139 n.7 (2d Cir. 2005), *rev'd on other grounds*, 127 S. Ct. 2383 (2007); CSFB Complaint, *supra* note 16, at para. 8; SEC, Initial Public Offerings, *supra* note 56 ("When an IPO is 'hot,' appealing to many investors, the demand for the securities far exceeds the supply of shares. The excess demand can only be satisfied once trading in the IPO shares begins.").

63. *See generally In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d at 306 ("[T]he IPO market of 1998–2000 was more extraordinary than the previous three hot issues markets."); NYSE/NASD IPO ADVISORY COMM., *supra* note 57, at 1, 4 (noting that the late 1990s was "a period in which an unusually large number of offerings traded at extraordinary and immediate aftermarket premiums"). IPO shares would frequently double or triple in price on the first day of trading. For example, shares of the company VA Linux rose from an initial offering price of $30 to $239 in the first day of trading, an increase of 697 percent. *See* CSFB Complaint, *supra* note 16, at para. 54. Of course, there is no guarantee that over time the initial rise in price is sustainable. *See, e.g.*, Howard Schilit, FINANCIAL SHENANIGANS 104–08 (2d ed. 2002) (describing collapse of Boston Chicken stock after a successful IPO).

64. *See* CSFB Complaint, *supra* note 16, at para. 15.

investor conducts with the brokerage division of the investment bank.[65] Broker-dealers earn much of their revenue by charging a commission for executing securities transactions. Typically, for institutions, the commission rate for an equity transaction is $0.06 per share.[66] Large institutions managing billions of dollars have the ability to generate more for the broker-dealers in commissions from securities transactions than do individual investors with small portfolios.[67]

2. *The Enforcement Action against Credit Suisse First Boston*. In 1999, CSFB managed more domestic IPOs than any other U.S. investment bank.[68] As a result, it had access to a large number of "hot IPOs" that it allocated to favored customers. CSFB entered into explicit arrangements with certain customers allowing it to capture a part of the "hot IPO" profits.[69] In return for allocations in a "hot IPO," the customer would agree to funnel back as much as 65 percent of its IPO profits to CSFB.[70] Customers repaid IPO profits by generating commissions on unrelated securities transactions.[71] On the days around an IPO, the customer would buy highly liquid securities, such as shares in IBM or Procter & Gamble, through CSFB's brokerage division. Instead of paying the normal $0.06 per share commission on these transactions, the customer would pay commissions as high as $3.15 per share on the transaction. The

65. *Id.* at para. 13; *see also* Arthur Levitt, Chairman, SEC, Speech at the Los Angeles Times Fourth Annual Investment Strategies Conference: Investing with Your Eyes Open (Feb. 12, 2000), *available at* http://www.sec.gov/news/speech/spch345.htm ("Shares often are allocated according to business relationships and other subjective criteria.").

66. *See* CSFB Complaint, *supra* note 16, at para. 46. This commission covers the cost of execution and the value of advice and other services such as research provided by the broker-dealer.

67. Coffee, *supra* note 60 ("[L]arge institutional investors implicitly pay for receiving priority in the allocation of 'hot' offerings by directing their brokerage business to the major underwriters. . . . [A large mutual fund] could direct this brokerage business to a cheap discount broker, or it could negotiate a somewhat higher commission rate with a broker dealer that was also a major underwriter in return for a priority in the latter's IPO allocations."); *see also* Jonathan Reuter, *Are IPO Allocations for Sale? Evidence from Mutual Funds*, 61 J. OF FIN. 2289, 2290, 2322 (2006) (finding that underwriters allocate based on amount of overall "brokerage business").

68. News Release, NASD Regulation, Inc., Statement of Mary Schapiro on Announcement of CSFB Action (Jan. 22, 2002), *available at* http://www.finra.org/PressRoom/NewsReleases/2002NewsReleases/P002966.

69. CSFB Complaint, *supra* note 16, at paras. 19–20.

70. *Id.* at paras. 42–43.

71. *Id.* at paras. 21–22.

customer would then sell the securities through another broker-dealer, paying the normal $0.06 per share commission.[72]

The scheme involved entities too small to generate the commission business needed to receive an IPO allocation.[73] Thus, most of the customers paid the commissions willingly, because while they had to return a portion of their profits, they still earned a substantial profit on the transaction.[74]

In December 2000, after reports in the *Wall Street Journal* noted unusual commission activity on the days before and after many IPOs, regulators began investigating CSFB's IPO allocation practices.[75] On January 22, 2002, the SEC and NASD announced a settlement with CSFB.[76] The primary substantive count alleged was a violation of NASD Rule 2330(f), which prohibits brokers from sharing in the profits of their customers.[77] CSFB's conduct was also alleged to violate NASD Rule 2110, which requires brokers to comport with high standards of commercial honor, a standard charge in NASD actions.[78] CSFB agreed to pay $70 million in disgorgement, pay a $30 million penalty, implement policies and procedures governing IPO

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72. *Id.* at para. 22.

73. *Id.* at para. 2.

74. *Id.* at para. 20.

75. *See* Susan Pulliam et al., *Coming to Terms: CSFB Agrees to Pay $100 Million to Settle Twin IPO Investigations—Probes by SEC and NASD Grew out of Conduct During Dot-Com Frenzy—A Legacy of Wheat's Reign*, WALL ST. J., Dec. 11, 2001, at A1 ("Investigators began focusing last year on CSFB's alleged practice of awarding shares of hot IPOs to some investors who agreed to pay the firm large commissions on other transactions. As detailed in a series of Wall Street Journal stories beginning in December 2000, some of these commissions came on big batches of trades at hugely inflated rates.").

76. SEC Sues CSFB for IPO Violations; CSFB Will Pay $100 Million, *supra* note 53; News Release, NASD Regulation, Inc., *supra* note 68.

77. *See* CSFB Complaint, *supra* note 16, at paras. 74–75. NASD Rule 2330(f) provides in relevant part:

> [N]o member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member; provided, however, that a member or person associated with a member may share in the profits or losses in such an account if (i) such person associated with a member obtains prior written authorization from the member employing the associated person; (ii) such member or person associated with a member obtains prior written authorization from the customer; and (iii) such member or person associated with a member shares in the profits or losses in any account of such customer only in direct proportion to the financial contributions made to such account by either the member or person associated with a member.

Nat'l Ass'n of Sec. Dealers, NASD Manual, Rules of the Association, Rule 2330(f)(1)(A), http://finra.complinet.com/finra/index.html (last visited Nov. 27, 2007).

78. CSFB Complaint, *supra* note 16, at paras. 70–72.

allocations, and hire an independent consultant to monitor its compliance with the settlement.[79]

3. *Lack of Regulation.* The CSFB IPO case broke new ground. Prior to the CSFB case, the SEC's position was that underwriters could allocate IPO shares however they wanted to their customers.[80] As it had explained to investors in a release: "The underwriters and the company that issues the shares control the IPO process. They have wide latitude in allocating IPO shares. The SEC does not regulate the business decision of how IPO shares are allocated."[81] The SEC Chairman, Arthur Levitt, approved of allocating "hot IPOs" to customers who generated the most commission business, calling it a "good business practice, in the same way that an automobile dealer will allocate the first new, highly desired car to a customer that had been with them for a period of time."[82] The SEC and NASD had investigated the practice of allocating "hot IPO" shares to top executives in 1997 but brought no action.[83]

The SEC's citation of NASD Rule 2330(f) in the CSFB case was not the simple application of a rule.[84] As reported by the *Wall Street*

79. *See* SEC v. Credit Suisse First Boston Corp., No. 1: 02-00090-RWR, 2002 WL 479836, at *2 (D.D.C. Jan. 29, 2002).

80. NASD rules prohibit underwriters from allocating IPO shares to themselves, relatives, or to accounts where they have a "beneficial interest." Nat'l Ass'n of Sec. Dealers, NASD Manual, Rules of the Association, Rule 2790, http://finra.complinet.com/finra/index.html (last visited Nov. 27, 2007).

81. SEC, Initial Public Offerings, *supra* note 56; *see also* John C. Coffee, *The SEC's IPO Probe*, NAT'L L.J., July 9, 2001, at B8 ("No duty to prorate IPO stock among all customers, or to otherwise apportion it 'fairly' has ever been recognized within the industry."); SEC, *Allocation of New Issues of Securities*, 1994 WL 744595, at *1 (Oct. 18, 1994) ("Broker-dealers are free to establish their own procedures and priorities for allocating new shares to investors, as long as the allocation is not conducted in a fraudulent or manipulative manner and is consistent with the rules of the broker-dealers' self-regulatory organization (SRO). . . . None of the SROs, however, prescribe procedures that broker-dealers must use to allocate offering securities among their customers.").

82. Interview by Martin Smith with Arthur Levitt, Former Chairman, SEC (May 2001), *available at* http://www.pbs.org/wgbh/pages/frontline/shows/dotcon/interviews/levitt.html; *see also* Levitt, *supra* note 65 ("Shares often are allocated according to business relationships and other subjective criteria.").

83. *See* Randall Smith, *NASD Proposes Tougher Rules on IPO Abuses—Agency Would Bar Brokers from Allocating Hot Issues To Curry Favor with Clients*, WALL ST. J., July 29, 2002, at A1 ("Although both the SEC and NASD investigated spinning [in response to a 1997 *Wall Street Journal* article], neither agency brought a case against any major firm.").

84. NASD Rule 2330(f) provides: "Except as provided in paragraph (f)(2) no member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member . . . ." Nat'l Ass'n of Sec.

Journal, there was internal dissension among regulators about what rule to apply.[85] NASD Rule 2330(f) had not been understood as regulating IPO allocation decisions. Although CSFB's conduct fell within NASD Rule 2330(f) in a literal sense in that CSFB was requiring customers to share their guaranteed IPO profits by returning part of the profits through excessive commissions, it did not fall within the original purpose of that rule, which was to protect retail customers from conflicts of interest that could arise when brokers had an interest in their investments.[86] In contrast, unlike the typical NASD Rule 2330(f) case, CSFB involved sophisticated customers who knew exactly what they were doing. Even with the requirement to pay back a portion of the profits, they knew they would receive a substantial return with little or no risk.[87]

4. *The Commercial Bribery Principle*. A more convincing theory is that CSFB's quid pro quo arrangements with its customers violated a principle against commercial bribery,[88] which reflects the

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Dealers, NASD Manual, Rules of the Association, Rule 2330(f)(1)(A), http://finra.complinet.com/finra/index.html (last visited Nov. 27, 2007).

85. *See* Pulliam et al., *supra* note 75 ("In the CSFB case, the regulators have struggled with what law to apply to the firm's practices.").

Early speculation had been that the conduct could violate other rules such as the Free-riding and Withholding Rules or bans against undisclosed underwriting compensation. *See* Susan Pulliam & Randall Smith, *Two at CSFB Put on Leave amid IPO Probe—Action Shows Inquiry Touches Tech Team of Frank Quattrone*, WALL ST. J., Apr. 20, 2001, at C1.

86. NASD Rule 2330(f) was modeled after section 205 of the Investment Advisers Act, which also prohibits certain profit sharing arrangements. *See* NASD Notice to Members 01-24: SEC Approves Proposed Rule Changes to Rule 2330(f)(2) Relating to Performance Fees (Apr. 2001), *available at* http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003885.pdf. The legislative history of Section 205 indicates that the rationale for the prohibition against profit sharing was the concern that customers would be harmed if advisers had an incentive to make risky investments in hopes of a larger fee. *See* Exemption To Allow Registered Investment Advisors to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, 50 Fed. Reg. 48,556, 48,557 (Nov. 26, 1985) ("Congress enacted the prohibition of Section 205(1) against performance fees in 1940 to protect clients of investment advisers from fee arrangements which in Congress' view could encourage advisers to engage in speculative trading practices while managing client funds in order to realize or increase an advisory fee.").

87. *See* Coffee, *supra* note 81.

88. *See The Impact of the Global Settlement: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 44 (2003) (statement of Robert E. Glauber, Chairman and CEO, National Association of Securities Dealers) (describing enforcement actions as underscoring the principle "that hot IPOs cannot be doled out to corporate insiders as virtual commercial bribes").

public importance of markets that function without kickbacks.[89] By paying commission rates greater than the market price, CSFB's customers were essentially paying kickbacks or commercial bribes in return for IPO allocations. In another sense, CSFB was bribing its customers through IPO allocations to pay greater than market prices for its brokerage services. Although commercial bribery is not specifically prohibited by NASD Rules, NASD Rule 2110 sets forth a general principle that broker-dealers are required to "observe high standards of commercial honor and just and equitable principles of trade" in the "conduct of [their] business."[90] Given that commercial bribery is widely prohibited by other statutes,[91] it follows that bribery would violate "high standards of commercial honor and just and equitable principles of trade."

One objection to this theory is that there is no substantial difference between a smaller customer paying above-market commissions to obtain IPO allocations and larger customers obtaining IPO allocations by directing a large volume of trades at market prices. Both are attempting to pay something to get something.[92] But the quid pro quo agreements found in the investigation of CSFB made it clear that the allocations were not based on the status of the customer but instead were part of an explicit kickback arrangement. Moreover, the excessive commissions paid by CSFB customers did not reflect the purchase of legitimate services. Under Section 28(e) of the Securities Exchange Act, an investment manager may lawfully pay a commission higher than the market commission rate only "if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided."[93] The commissions in the CSFB case were so

89. *See generally* 12 AM. JUR. 2D *Bribery* § 1 (2007) ("[B]ribery is the criminal offense of offering, giving, soliciting, accepting, or agreeing to accept something of value with an intent to corruptly influence the action of . . . an employee of a private business . . . . The purpose of bribery is to cause certain matters that should be decided or handled in an objective way to be decided or handled in the private interest of the bribegiver or the bribetaker. It is something that directly affects the community at large. It offends the public sense of decency and tends to pervert justice." (footnotes omitted)).

90. Nat'l Ass'n of Sec. Dealers, NASD Manual, Rules of the Association, Rule 2110, http://finra.complinet.com/finra/index.html (last visited Oct. 12, 2007).

91. *See generally* D.E. Ytreberg, Annotation, *Validity and Construction of Statutes Punishing Commercial Bribery*, 1 A.L.R.3d 1350 (1965) (collecting state and federal commercial bribery statutes).

92. *See, e.g.*, Coffee, *supra* note 81.

93. *See* Securities Exchange Act of 1934 § 28(e), 15 U.S.C. § 78bb(e) (2000).

excessive that they could not have been for legitimate brokerage and research services.[94]

In essence, the CSFB case established that allocations of "hot IPO" shares should not be used as commercial bribes. This general principle was then extended to question a number of different IPO allocation practices through rulemaking and enforcement.[95] After the CSFB case, practices such as "spinning," in which "hot IPO" shares were allocated to company officers and directors in exchange for investment banking business,[96] and "laddering," in which "hot IPO" shares were allocated in exchange for an agreement to purchase additional shares of the IPO in the aftermarket, were closely scrutinized.[97] For example, the New York Attorney General brought suit against directors of WorldCom for their involvement in

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94. Indeed, the typical market commission of $0.06 per share already includes an extra payment for research and other services. Thus, payments of $1.00 per share go far beyond the industry standard for a reasonable commission.

95. On July 25, 2002, the NASD proposed conduct rules regulating IPO abuses. News Release, Nat'l Ass'n of Sec. Dealers, NASD Board Approves Proposed Conduct Rules for IPO Activities (July 25, 2002), *available at* http://www.finra.org/PressRoom/NewsReleases/2002NewsReleases/P002921. It proposed explicitly prohibiting the quid pro quo arrangements at issue in the CSFB case as well as "spinning" and "laddering." *Id.* In August 2002, at the request of the SEC Commissioner, the NYSE and NASD formed the NYSE/NASD IPO Advisory Committee to study the IPO process. *See* NYSE/NASD IPO ADVISORY COMM., *supra* note 57, at app. A. In May 2003, the NYSE/NASD IPO Advisory Committee published its report, recommending various measures to improve the transparency of the IPO process, including the prohibition of laddering, spinning, and quid pro quo arrangements. *Id.* at 10–13.

In addition to these structural reform proposals, the CSFB investigation was followed by a number of enforcement actions against other market participants. *See, e.g.*, SEC Sues J.P. Morgan Securities Inc. for Unlawful IPO Allocation Practices; J.P. Morgan Agrees to Settlement Calling for Injunction and Payment of $25 Million Penalty, SEC Litigation Release No. 18385 (Oct. 1, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18385.htm; SEC Sues Robertson Stephens, Inc. for Profit Sharing in Connection with Initial Public Offerings; Robertson Stephens Consents to Pay $28 Million, SEC Litigation Release No. 17923 (Jan. 9, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr17923.htm; News Release, Nat'l Ass'n of Sec. Dealers, NASD Fines J.P. Morgan for Sharing in Profits from Hot IPOs (Feb. 20, 2003), *available at* http://www.finra.org/PressRoom/NewsReleases/2003NewsReleases/P002951; News Release, Nat'l Ass'n of Sec. Dealers, NASD Sanctions Investment Banks for IPO Violations: Bear Stearns, Deutsche Bank and Morgan Stanley to Pay Over $15 Million (May 18, 2004), *available at* http://www.finra.org/PressRoom/NewsReleases/2004NewsReleases/P002829.

96. *Cf.* Griffith, *supra* note 56, at 623–30, 637–43 (discussing the hypothesis that spinning "may amount to a quid pro quo arrangement, according to which the managers accept the benefit of the allocation in exchange for the underpricing of their company's offering").

97. *See, e.g.*, Billing v. Credit Suisse First Boston Ltd., 426 F.3d 130, 144 (2d Cir. 2005) ("The purported 'bribes' consisted of underwriter promises to make 'exceptionally large' allocations of IPO securities in return for the institutional defendants' promises to comply with the rules set by the underwriter defendants for the resale of the securities and to divide profits with them."), *rev'd on other grounds*, 127 S. Ct. 2383 (2007).

"spinning." In February 2006, a New York state court ruled that "spinning" was "merely a somewhat sophisticated form of bribery."[98] Through the CSFB case, securities regulators asserted a principle against commercial bribery that was extended to other practices.

B. The Research Analyst Cases

A second example is the enforcement action initiated by the New York Attorney General targeting the practices of Wall Street research analysts. To win investment banking business, research analysts knowingly issued false opinions in their research reports and recommendations. The investigation of these practices established that these research recommendations were violating the anti-fraud principle.

1. *The Merging of Research and Investment Banking.* Research analysts grade public companies. They analyze the financials of a company, speak to management, interview customers, and form an opinion about the company's future prospects.[99] This opinion is often expressed through a scale of recommendations to buy, hold, or sell the stock.[100] These opinions, predictions, and their bases are published in research reports that are distributed to investors and can influence the price of a stock.[101]

Most investment banks do not directly charge for research. Part of the commission clients pay for execution of equity transactions is understood as paying for research.[102] As competition among brokerage firms increased, commission rates went down and the revenue generated by analysts declined. As a result, research analysts began serving the needs of investment bankers because of their inability to generate revenue independently.[103] At the same time, the

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98. State of New York v. McLeod, No. 403855/02, 2006 N.Y. Misc. LEXIS 1227, at *2 (Sup. Ct. Feb. 9, 2006).

99. *See, e.g.*, Complaint at paras. 15–17, SEC v. J.P. Morgan Sec. Inc. 03 Civ. 2939, (S.D.N.Y. Apr. 28, 2003); SEC, Investor Alert: Analyzing Analyst Recommendations, Apr. 20, 2005, http://www.sec.gov/investor/pubs/analysts.htm.

100. *See* SEC, *supra* note 99.

101. *See id.*

102. This is permissible under section 28(e) of the Securities Exchange Act. *See* Securities Exchange Act of 1934 § 28(e), 15 U.S.C. § 78bb(e) (2000).

103. *See* Complaint at para. 18, SEC v. Merrill Lynch, Pierce, Fenner & Smith Inc., 03 CV 2941 (S.D.N.Y. Apr. 28, 2003); Jonathan R. Macey, *Positive Political Theory and Federal Usurption of the Regulation of Corporate Governance: The Coming Preemption of the Martin*

investment banking business became much more competitive as the dominance of a few elite firms offering investment banking services waned.[104] Competition became especially intense to be the lead underwriter who runs the securities offering, receives the greatest portion of fees, and is in charge of allocating IPO shares.[105]

To distinguish themselves from their competitors, investment banks began using research coverage to obtain underwriting business. A credible research analyst might be an attractive reason for an issuer to choose the investment bank as lead underwriter.[106] A favorable report by a research analyst gives credibility to a new company that is

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Act, 80 NOTRE DAME L. REV. 951, 971 (2005) ("In response to complaints that brokerage commissions had sunk so low that brokers could no longer afford to pay analysts, analysts became more involved in marketing IPOs in order to justify their retention by investment banks.").

104. *See* DAN REINGOLD, CONFESSIONS OF A WALL STREET ANALYST 36 (2006). Reingold describes

> the end of the genteel old world of banking, in which belonging to the same country club and living in the same town was as much of a draw for a corporate executive choosing a banker as the actual services the bank was offering. As banking became more competitive, these relationships weren't enough anymore. Banks needed to offer something extra, some special sauce. As time went on, that special sauce would often involve bullish research.

Id.

105. *See, e.g.*, Complaint at para. 17, SEC v. U.S. Bancorp Piper Jaffray Inc., 03 Civ. 2942 (S.D.N.Y. Apr. 28, 2003) [hereinafter U.S. Bancorp Complaint]; Complaint at para. 15, SEC v. Morgan Stanley & Co., 03 Civ. 2948, (S.D.N.Y. Apr. 28, 2003) [hereinafter Morgan Stanley Complaint] ("Morgan Stanley typically competed with other investment banks for selection as the lead underwriter, or 'bookrunner,' for securities offerings, including IPOs and follow-on offerings. . . . Sole or joint bookrunners generally received the largest portion of underwriting fees, which were typically divided among the participating investment banks. The bookrunner also established the allocation of shares in an offering and typically retained the greatest number of shares for itself. The typical IPO generated millions of dollars in investment banking fees for the bookrunner.").

106. *See* Morgan Stanley Complaint, *supra* note 105, at para. 16 ("In selecting the lead underwriters, issuers assessed a host of factors, including the strength and quality of the bankers' research coverage. Issuers sought research coverage of their stocks, believing such coverage would enhance the credibility of their businesses, potentially lead to higher stock prices, and increase their exposure to the investing public."); REINGOLD, *supra* note 104, at 75 ("[A] bank's research analyst was beginning to be one of the most important factors determining which investment banks companies and countries chose to handle their deals."); Jill E. Fisch, *Regulatory Responses to Investor Irrationality: The Case of the Research Analyst*, 10 LEWIS & CLARK L. REV. 58, 63–64 ("In the late 1990s, Wall Street research analysts were powerful and influential. . . . The ability of an investment bank's research department to influence investor sentiment was a key factor in the bank's ability to attract underwriting business.").

entering the public markets for the first time and could increase the initial price at which its stock trades.[107]

2. *The New York Attorney General's Investigation of Merrill Lynch*. In June 2001, the New York Attorney General began an investigation of all stock recommendations made by Merrill Lynch internet research analysts.[108] On April 8, 2002, a New York state court granted the New York Attorney General's motion for a preliminary injunction against Merrill Lynch.[109] The motion contained e-mail evidence that Merrill Lynch research analysts had secretly denigrated stocks they recommended to the public.

In essence, the motion alleged that analysts publicly recommended stocks while privately expressing negative opinions about those stocks.[110] They did so because they were pressured by investment bankers and issuers to alter their reports.[111] There was pressure because Merrill Lynch used the implicit promise of favorable ratings from a high-profile analyst to obtain investment banking business.[112] Research analysts were motivated to give in because their compensation depended upon the amount of investment banking revenue they helped bring in.[113]

The New York Attorney General's action alleged violations of New York's securities anti-fraud statute, the Martin Act.[114] In May 2002, Merrill Lynch agreed to settle the case for a $100 million fine

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107. Interview by Martin Smith with Arthur Levitt, *supra* note 82 ("When fixed commissions were eliminated [in 1975], more and more of Wall Street's profits had to come from investment banking. But what is the very best way to get investment banking business? The language of Wall Street is, 'We'll get you coverage.' And what kind of coverage does that mean? An overwhelming number of research reports written about investment banking clients are favorable.").

108. *See* Dinallo Aff., *supra* note 16, at 2.

109. *See In re* Spitzer v. Merrill Lynch & Co., No. 02-401522 (N.Y. Sup. Ct. Apr. 8, 2002) (order granting a preliminary injunction).

110. *See* Dinallo Aff., *supra* note 16, at 13 (detailing in a chart instances in which public rating diverged from private comments).

111. *See id.* at 17, 20–23 ("Investment banking also was involved in criticizing and editing the internet group's reports for client companies, opining on whether a particular rating would be acceptable and, in at least one instance, apparently opposing a proposed rating.").

112. *See id.* at 15–17.

113. *See id.* at 20–21.

114. *See* Martin Act, N.Y. GEN. BUS. LAW § 352 et seq. (McKinney 2006); Affidavit of Eric R. Dinallo, *supra* note 16, at 35–37.

and take steps to better manage the relationship between investment banking and research.[115]

3. *Lack of Regulation.* Prior to the New York Attorney General's action, it was widely known among sophisticated investors that investment banks were using research analysts to generate investment banking business.[116] As early as 1996, academic studies and the media noted that this was a conflict of interest that led to biased reports.[117] Yet regulators did little to address the problems. There were no SEC, NASD, or NYSE rules directly regulating the relationship between investment bankers and research analysts.[118] As the SEC chief of enforcement commented in a *Wall Street Journal* article on conflicts of interest relating to research analysts in 1997, "There are no hard and fast federal laws that say you can do this and you can't do this . . . . It really is a question of navigating the problem case by case."[119] Moreover, an SEC no-action letter in 1997 allowed Merrill Lynch's research analysts to comment on deals in which Merrill Lynch was the investment banker,[120] implicitly legitimizing the interaction between research and banking.

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115. *See* Charles Gasparino, *Merrill Lynch to Pay Big Fine, Increase Oversight of Analysts—New York Attorney General Wins $100 Million Penalty; E-mails Exposed Research*, WALL ST. J., May 22, 2002, at A1.

116. *See* Barbara Moses, *They Were Shocked, Shocked: The "Discovery" of Analyst Conflicts on Wall Street*, 70 BROOK. L. REV. 89, 91 (2004) ("[T]he basic facts 'discovered' by Eliot Spitzer, by other regulators, and ultimately by the plaintiffs' bar after the collapse of the Internet bubble were actually well known to sophisticated market participants throughout the 1990s."). Indeed as early as 1992, the *Wall Street Journal* published an article describing one investment bank's policy that research analysts not make negative comments about investment banking clients. *See* Michael Siconolfi, *At Morgan Stanley, Analysts Were Urged to Soften Harsh Views*, WALL ST. J., July 14, 1992, at A1.

117. *See, e.g.*, *In re* Merrill Lynch & Co. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 383–88 (S.D.N.Y. 2003) (collecting examples of news stories describing analyst conflicts of interest); *Wall Street Has an Unlikely New Cop: Spitzer—State Office, Used to Policing Junk Mail, Finds Fertile Ground in Stock Research*, WALL ST. J., Apr. 25, 2002, at C1 ("For years, newspaper articles have detailed how Wall Street firms provided overly optimistic research about companies that were investment banking clients, he noted, but there was no serious effort by regulators to address this issue.").

118. *See* Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 790 (2006) ("For various reasons, courts and commentators were hostile to SEC regulation of securities analysts, who remained relatively unregulated until recently.").

119. Anita Raghavan, *Jack of All Trades: How One Top Analyst Vaults 'Chinese Wall' To Do Deals for Firm—For Salomon, Grubman is Big Telecom Rainmaker; Investors Heed Him, Too—A Role That's Hard to Police*, WALL ST. J., Mar. 25, 1997, at A1.

120. *See* Merrill Lynch, Pierce, Fenner & Smith Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1014, at *4 (Oct. 21, 1997).

The sentiment may have been that the problem could be solved through rulemaking. In 1999, two years before the New York Attorney General's suit, the SEC's Division of Market Regulation began reviewing the research analyst industry for conflicts of interest.[121] In testimony before Congress in 2001, almost a year before the Attorney General filed suit, the acting SEC Chairman reported with respect to the results of this review: "I recently called on the industry to take an active role in dealing with these and other problems surrounding analysts' conflicts of interest. . . . [T]he industry, as well as the self-regulatory organizations (SROs) have heard this call to action."[122] The SEC initiated rulemaking on the issue.[123]

4. *The Anti-Fraud Principle.* Rather than deferring to the SEC's rulemaking approach for managing conflicts of interest, the New York Attorney General issued subpoenas and initiated an investigation of research analyst practices. That investigation uncovered evidence of specific fraud by a high-profile research analyst at a premier firm.[124]

In essence, fraud is a knowing misrepresentation made to induce action by an individual who suffers harm as a result of relying on that misrepresentation.[125] The evidence uncovered by the New York

121. Lori Richards, Dir., Office of Compliance Inspections & Examinations, SEC, Speech to the Fin. Women's Ass'n: Analysts Conflicts of Interest: Taking Steps to Remove Bias (May 8, 2002), *available at* http://www.sec.gov/news/speech/spch559.htm.

122. *Analyzing the Analysts: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 107th Cong. 228, 229 (2001) (written statement of Laura S. Unger, acting chair, SEC).

123. *See* Gasperino & Schroeder, *supra* note 13 ("The SEC chairman believed that the solution to the problem was developing a new set of national standards for analysts, while at the same time directing self-regulatory organizations, such as the National Association of Securities Dealers and the New York Stock Exchange, to examine conflicts of interest and draw up new rules on analyst compensation and disclosure practices.").

124. *See* Dinallo Aff., *supra* note 16, at 36.

125. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005). The New York Attorney General investigates and prosecutes fraud based on a broadly worded New York State statute called the Martin Act. Martin Act, N.Y. GEN. BUS. LAW, § 352 et seq. (McKinney 2006). While the Martin Act is a broad statute, it basically covers the same type of fraud prohibited by the federal securities laws. However, there are differences between the two statutory regimes. Federal securities law requires the showing of scienter or proof that the misrepresentation was made knowingly. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976). In contrast, the Martin Act does not require such a showing. *See* People v. Federated Radio Corp., 154 N.E.

Attorney General left little doubt that at least some research analysts were knowingly making misrepresentations to the public. Analysts made positive comments about companies in their research reports, recommending that the public buy stock in the companies, while secretly recognizing that the stocks they were recommending were of poor quality. Even general statements of belief can be actionable as fraudulent if they are known to be false.[126] Because research reports are widely disseminated to the public, and used by investment advisers to recommend stocks to investors, the analyst recommendations were made with the purpose of inducing reliance. As a result of their reliance on false recommendations, investors who purchased stock in companies that later declined substantially in value were damaged.

This clear violation of the basic anti-fraud principle in a high-profile case trumped the lack of precise rules governing research analysts. The result was a remarkable and monumental shift in the relationship between investment bankers and research analysts. The SEC followed the New York Attorney General's lead and brought principles-based enforcement actions against Merrill Lynch and other companies.[127] The Merrill Lynch case also led regulators to promulgate rules regulating the relationship between research analysts and investment bankers.[128] Ultimately, it resulted in the separation of investment banking and research among major Wall

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655, 658 (N.Y. 1926). In the Merrill Lynch case, while the case was brought under the broader state statute, it appears the scienter requirement was met.

The Martin Act was enacted by the New York State Legislature in 1921, giving the Attorney General the power to investigate securities transactions and seek injunctive relief. Act of May 7, 1921, 1921 N.Y. Laws 1989. In 1955, the New York State Legislature added section 352-c to the Martin Act, giving the Attorney General the power to seek criminal indictments in securities fraud cases. Act of Apr. 21, 1955, 1955 N.Y. Laws 1255.

126. *See* Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1095 (1991).

127. *E.g.*, SEC v. Merrill Lynch & Co., SEC Litigation Release No. 18083, Accounting and Auditing Enforcement Release No. 1742 (Mar. 17, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18038.htm.

128. On May 8, 2002, the SEC approved rules proposed in February 2002 by the NASD meant to regulate the relationship between research and investment banking. News Release, Nat'l Ass'n of Sec. Dealers, Statement of NASD Chairmen and CEO Robert R. Glauber Regarding SEC Approval of New Analyst Rules (May 8, 2002), *available at* http://www.finra.org/PressRoom/NewsReleases/2002NewsReleases/P002935. On October 3, 2002, the NYSE and NASD proposed additional rules relating to research analysts and the formation of a committee to investigate practices relating to IPOs. *See* News Release, Nat'l Ass'n of Sec. Dealers and N.Y. Stock Exch., NYSE, NASD Move to Strengthen Rules Concerning Analysts, IPOs Both Efforts In Support of Joint Effort with SEC, NY Attorney General (Oct. 3, 2002), *available at* http://www.finra.org/PressRoom/NewsReleases/2002NewsReleases/P002895.

Street firms[129] as well as the payment of a record settlement of $1.4 billion.[130]

C. The Mutual Fund Cases

The final example is the New York Attorney General's investigation of the mutual fund industry. Mutual funds entered into arrangements with hedge funds in which they exchanged the right to "market time"—or to make frequent transactions that the mutual fund otherwise prohibited because they reduced the value of the fund—for the commitment by the hedge fund to generate a certain amount of management fees by investing assets in a related mutual fund. These arrangements violated fiduciary duty and anti-fraud principles because mutual funds profited at the expense of investors while publicly proclaiming that they prohibited such practices.

1. *Mutual Funds.* A mutual fund is a pool of investments such as stocks or bonds managed by an expert. Investors who purchase shares in the fund pay annual fees equal to a percentage of the assets under management.[131] The financial success of a mutual fund depends

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129. On April 25, 2002, the SEC, NASD, NYSE and NASAA announced they were commencing a joint investigation with the New York Attorney General directed at research analysts. *See* Press Release, SEC, SEC Launches Inquiry into Research Analyst Conflicts (Apr. 25, 2002), *available at* http://www.sec.gov/news/press/2002-56.htm.

130. On December 20, 2002, regulators announced a $1.4 billion global settlement in principle with ten firms. *See* Press Release, SEC, SEC, NY Attorney General, NASD, NASAA, NYSE and State Regulators Announce Historic Agreement to Reform Investment Practices: $1.4 Billion Global Settlement Includes Penalties and Funds for Investors (Dec. 20, 2002), *available at* http://www.sec.gov/news/press/2002-179.htm. On April 28, 2003, the regulators announced the final settlement with those firms as well as additional factual findings. *See* Joint Press Release, SEC et al., Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking: Historic Settlement Requires Payments of Penalties of $487.5 Million, Disgorgement of $387.5 Million, Payments of $432.5 Million to Fund Independent Research, and Payments of $80 Million to Fund Investor Education and Mandates Sweeping Structural Reforms (Apr. 28, 2003), *available at* http://www.sec.gov/news/press/2003-54.htm. The firms paid a total of $875 million in penalties and disgorgement, $432.5 million to fund independent research, and $80 million to fund and promote investor education. *See id.* The firms agreed to wide-ranging structural reform, essentially separating research and investment banking. *See* SEC, SEC Fact Sheet on Global Analyst Research Settlements, Apr. 28, 2003, http://www.sec.gov/news/speech/factsheet.htm.

131. *See* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 IOWA J. CORP. L. 609, 614 (2001) ("Mutual funds historically have provided their shareholders with the ability to pursue a vast array of different investment objectives as co-owners of an entity offering three main services: diversified investment risk, professional investment management, and a redeemable security."); SEC, Invest Wisely: An Introduction to Mutual Funds, http://www.sec.gov/investor/pubs/inwsmf.htm (last visited Nov.

on its ability to attract assets.[132] With the market decline of the early 2000s, many mutual funds found the value of their assets shrinking as the value of their investments declined and investors pulled their money out of the stock market.[133] Many mutual funds were forced to look for other ways to attract assets. One source of assets was hedge funds, which are investment vehicles limited to sophisticated investors.

2. *The New York Attorney General's Investigation of Canary.* In 2002, the New York Attorney General received a tip that a hedge fund, Canary Capital Partners, LLC, had entered into secret arrangements with mutual funds allowing it to profit at the expense of other mutual fund investors.[134] The Attorney General's subsequent investigation found that hedge funds were systematically taking advantage of arbitrage opportunities arising from peculiarities in the way that mutual funds are priced. In particular, they were engaging in a practice called market timing,[135] which involves the frequent

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27, 2007); SEC, Mutual Funds, http://www.sec.gov/answers/mutfund.htm (last visited Nov. 27, 2007).

In the 1990s, mutual funds experienced unprecedented growth as millions of individuals began investing in securities in response to a rising stock market and the decline of traditional pension plans. *See Mutual Funds: Who's Looking Out for Investors?: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 174 (2003) (testimony of Stephen M. Cutler, Dir., Div. of Enforcement, SEC) ("With more than 95 million Americans invested in mutual funds, representing approximately 54 million U.S. households, and a combined $7 trillion in assets, mutual funds are a vital part of this nation's economy and millions of investors' financial security."); JOINT ECON. COMM., 107TH CONG., THE MUTUAL FUND INDUSTRY: AN OVERVIEW AND ANALYSIS 5 (2002) (reporting that mutual fund assets grew from $1.065 trillion in 1990 to $6.965 trillion in 2000).

132. *See* Ajay Khorana & Henri Servaes, Conflicts of Interest and Competition in the Mutual Fund Industry 2 (July 2004), *available at* http://ssrn.com/abstract=240596 ("[T]he revenues of mutual funds families are a function of assets under management.").

133. *See* Brian Reid & Stefan Kimball, *Mutual Fund Industry Developments in 2002*, 9 INVESTMENT COMPANY INST. 1, 2–4 (2003) (describing outflow in mutual fund investments).

134. BROOKE A. MASTERS, SPOILING FOR A FIGHT: THE RISE OF ELIOT SPITZER 135–41 (2006).

135. There were also allegations of "late trading," which violated existing rules. *See* 17 C.F.R. § 270.22c-1 (2007). This rule is referred to as the "forward pricing" rule. *See* Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8343, Investment Company Act Release No. 26,287, 68 Fed. Reg. 70,402, 70,403 (proposed Dec. 17, 2003) (describing the rule as the "forward pricing" rule). In 1968, the SEC passed this rule "in order to reduce riskless short-term trading in mutual funds by eliminating the ability to use late-breaking news to take advantage of NAVs fixed before that news was released to the markets." DH2, Inc. v. SEC, 422 F.3d 591, 593 (7th Cir. 2005).

purchase and sale of mutual fund shares to take advantage of "mutual fund mispricing that occurs when market prices for the fund's underlying securities have become stale due to events after the relevant trading market has closed."[136] This occurs especially with respect to international markets because of time differentials. Because mutual funds are priced only once a day,[137] the fund may rely upon the closing price of a foreign market that is several hours old in calculating the Net Asset Value (NAV) of the fund. To the extent that intervening events occur, that price may undervalue or overvalue the foreign security.[138] Hedge funds can make a quick profit by buying or selling mutual fund shares with an undervalued or overvalued NAV.

These practices harm the other investors in the mutual fund. First, market timing can lead to the dilution of investment gains.[139] When the value of a mutual fund increases, that gain is in a sense divided among the mutual fund's investors. When a market timer comes in after the fact and captures part of the gain, the gain must be divided among more parties. Second, market timing increases the transaction costs of the mutual fund because the frequent activity leads to higher commission expenses.[140] Mutual fund managers may find it harder to execute a long term strategy when they must buy and sell shares of stock in response to timing activity.[141]

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136. *DH2, Inc.*, 422 F.3d at 592; *see also* Canary Complaint, *supra* note 16, at para. 23 (discussing the strategy of market timing in mutual funds).

137. *See DH2, Inc.*, 422 F.3d at 592 ("A mutual fund's share price does not fluctuate throughout the trading day, but the prices of the securities held by the fund do.").

138. *Id.* at 593; *see also* Canary Complaint, *supra* note 16, at para. 23 (discussing how the market timing strategy involves using stale prices that do not reflect the value of a foreign security).

139. Canary Complaint, *supra* note 16, at para. 25; *see also* Jason T. Greene & Conrad S. Ciccotello, *Mutual Fund Dilution from Market Timing Trades*, 4 J. INVESTMENT MGMT. 31, 37 (2006) (discussing a model of mutual fund dilution).

140. Canary Complaint, *supra* note 16, at para. 27; *see also* SEC v. Pimco Advisors Fund Mgmt. LLC, 341 F. Supp. 2d 454, 458 (S.D.N.Y. 2004) ("[Market timing] can also harm investors . . . by increasing trading and brokerage costs, as well as tax liabilities, incurred by a fund and spread across all fund investors."); Christopher Oster & Karen Damato, *How Market Timers Can Drain Returns for Some Investors*, WALL ST. J., Sept. 8, 2003, at C1 ("Waves of cash flowing rapidly in and out of a fund increase the commissions that managers pay to buy and sell securities, and those expenses eat into returns.").

141. Canary Complaint, *supra* note 16, at para. 27; *see also Pimco Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d at 458 ("The quick pace of investments and redemptions associated with market timing may also hinder the ability of mutual fund managers to act in the best interests of fund investors who seek to maximize their long-term investment gains. It would make little

Because it harms their investors, many mutual funds represented in their prospectuses that they prohibited market timing. Contrary to these representations, the mutual funds agreed to allow certain investors such as hedge funds to market time their funds in exchange for an agreement to retain a significant amount of assets in their funds.[142] The mutual funds benefited because they earned management fees on these "sticky assets."

3. *Lack of Regulation.* Why did compliance departments or regulators fail to prevent these practices? Although many mutual funds themselves prohibited market timing, there was no rule prohibiting investors from making multiple transactions in a mutual fund. Indeed, there was evidence that the SEC knew the industry was allowing market timing.[143] The SEC, however, did not know of the agreements in which mutual funds allowed favored customers to market time in return for valuable consideration. Routine examinations of these mutual funds did not pick up the clandestine agreements to allow market timing because they did not review e-mails or trading activity.[144] Without such agreements, it is not clear why market timing should be prohibited. The thought may have been that the market could take care of any abuses from market timing. Funds allowing market timing would disclose that fact to investors. If market timing affected the fund's returns significantly, investors could choose to take their money elsewhere.

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sense for a fund manager to invest in assets with significant long-term potential but high short-term volatility if a market timer's redemptions could force the quick sale of fund assets.").

142. Canary Complaint, *supra* note 16, at paras. 30–33.

143. *See* Windsor Sec., Inc. v. Hartford Life Ins. Co., 986 F.2d 655, 658 (3d Cir. 1993) ("[As early as 1993,] Hartford . . . began to observe a negative impact caused by market timing activity: increased trading and transaction costs, disruption of planned investment strategies, forced and unplanned portfolio turnover, lost opportunity costs, and large asset swings in a fund's asset base that adversely affected Hartford's ability to provide maximal investment return to all contract owners."); Tamar Frankel & Lawrence Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing* 235, 256 (Boston College Law School Faculty Papers, Paper 187, 2007), *available at* http://lsr.nellco.org/cgi/viewcontent.cgi?article=1188&context=bc/bclsfp ("The SEC knew of the excessive purchases and redemptions of mutual fund investors. However, it seems to have assumed, perhaps reasonably, that fund managers had self-interest in preventing harmful turnover of investments."); Macey, *supra* note 103, at 965–66 ("Late trading and market timing were not only common practices, but the existence of such practices was well known to the SEC, which acquiesced in such practices until Mr. Spitzer came along to change the political climate.").

144. *See* Memorandum from Lori A. Richards, Office of Compliance Inspections & Examinations, to William H. Donaldson, Chairman, SEC, 3 (Mar. 10, 2004), *available at* http://www.sec.gov/news/extra/apx-ts031004lar.pdf.

4. *The Anti-Fraud and Fiduciary Duty Principles.* The New York Attorney General's investigation established that the way in which mutual funds allowed market timing violated basic principles governing investment companies such as mutual funds.

First, mutual funds that publicly proclaim they prohibit market timing while privately allowing it are making material misrepresentations to investors.[145] An investor choosing such a mutual fund relies on the premise that the mutual fund will prohibit practices that harm the fund's investors. By failing to disclose market timing arrangements, mutual funds harmed investors who might have chosen to place their assets in a mutual fund that did not allow timing of the market. This violates the anti-fraud principle embodied in section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5, and the Martin Act.[146]

Second, the market timing arrangements were illegal to the extent that the mutual fund managers benefited under those arrangements at the expense of their investors.[147] Mutual fund managers are investment advisers and have basic fiduciary duties to their investors.[148] A fundamental fiduciary principle is that the fiduciary may not benefit at the expense of the party to whom it has a fiduciary duty.[149] Mutual fund managers benefited from market timing arrangements that harmed investors because they earned greater management fees. This violates the fiduciary duty principle embodied

145. *See Pimco Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d at 464.

146. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2000); 17 C.F.R. § 240.10b-5 (2007); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) (noting that legislative history described section 10(b) as a "catchall" clause enabling the SEC "to deal with new manipulative [or cunning] devices" (quoting a statement of Thomas Corcoran made on behalf of the section's drafters during the Hearings before the House Committee on Interstate and Foreign Commerce) (internal quotations omitted, bracketed insertion in original)).

147. *See In re* Mut. Funds Inv. Litig., 384 F. Supp. 2d 845, 856 (D. Md. 2005) ("Although market timing itself may be lawful, it nevertheless is prohibited by Rule 10b-5 if it is engaged in by favored market insiders at the expense of long-term mutual fund investors from whom it is concealed and who have a right to rely upon its prevention by fund advisers' and managers' good faith performance of their fiduciary obligations."); *Pimco Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d at 472.

148. Investment Company Act of 1940 § 36(a), 15 U.S.C. § 80a-35 (2000); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) ("The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."); EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 31–32 (N.Y. 2005) (recognizing a common-law fiduciary duty).

149. RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006).

in the Investment Company Act of 1940 as well as common law principles.

The New York Attorney General's enforcement action demonstrated that market timing, although not itself illegal, was being conducted in a way that violated fundamental principles. The SEC followed the New York Attorney General's lead, and the two regulators brought additional enforcement actions, which revealed that abusive market timing arrangements were widespread.[150] As a result, the SEC proposed a wide range of new rules and regulations to reform the mutual fund industry.[151]

III. COMPETING PARADIGMS

Although popular with the public, at least a portion of the business community has argued that principles-based enforcement actions are disruptive and unfair. For the most part, the regulated generally prefer the more predictable rulemaking approach. In contrast, the public generally prefers the decisiveness of principles-based enforcement. To some extent, these attitudes reflect different assumptions about the regulatory scheme and its goals. In this Part, I show how rulemaking reflects an administrative paradigm preferred by the regulated whereas principles-based enforcement reflects a public values paradigm preferred by the public.

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150. *See, e.g.*, *In re* Canadian Imperial Holdings Inc., Securities Act Release No. 8593, Exchange Act Release No. 52,064, Administrative Proceeding File No. 3-11987 (July 20, 2005), *available at* http://www.sec.gov/litigation/admin/33-8593.pdf; *In re* Banc of Am. Capital Mgmt., LLC, Securities Act Release No. 8538, Exchange Act Release No. 51,167, Investment Company Act Release No. 26,756, Administrative Proceeding File No. 3-11818 (Feb. 9, 2005), *available at* http://www.sec.gov/litigation/admin/33-8538.htm; *In re* Janus Capital Mgmt. LLC, Investment Company Act Release No. 26,532, Administrative Proceeding File No. 3-11590 (Aug. 18, 2004), *available at* http://www.sec.gov/litigation/admin/ia-2277.htm; *In re* Strong Capital Mgmt., Inc., Exchange Act Release No. 49,741, Investment Company Act Release No. 26,448, Administrative Proceeding File No. 3-11498 (May 20, 2004), *available at* http://www.sec.gov/litigation/admin/34-49741.htm; *In re* Mass. Fin. Servs. Co., Investment Company Act Release No. 26,347, Administrative Proceeding File No. 3-11393 (Feb. 5, 2004), *available at* http://www.sec.gov/litigation/admin/ia-2213.htm; *In re* Alliance Capital Mgmt., L.P., Investment Company Act Release No. 26,312, Administrative Proceeding File No. 3-11359 (Dec. 18, 2003), *available at* http://www.sec.gov/litigation/admin/ia-2205.htm.

151. *See, e.g.*, Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 8408, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300 (Apr. 23, 2004).

A. Rulemaking and the Administrative Paradigm

There is evidence that for the most part, the regulated prefer that regulators utilize rulemaking over principles-based enforcement actions because it is a deliberative approach that they can influence.[152] The regulated may not be comfortable with applying broad principles to particular circumstances, an art monopolized by lawyers trained in common-law reasoning.[153] Principles may give regulators discretion that potentially can be abused.[154] The regulated want clear rules that specifically tell them what they cannot do, and more importantly, what they can do.[155] The regulated may view questionable conduct as justified because the rules are unclear. They would prefer that the regulator clarify the law, not punish the conduct.

The "Regulation by Enforcement" critique described in Part I of this Article reflects this mentality. The critique has tended to reemerge in response to periods of intensive enforcement activity. In 2006 the Committee on Capital Markets Reform issued a report criticizing securities regulators for sidestepping the rulemaking process through enforcement actions.[156] The sentiment reflected by this report is likely to be shared by a significant proportion of the regulated.

Rulemaking reflects an administrative paradigm with three characteristics. First, regulatory norms should be defined through the application of administrative expertise. Second, regulatory norms should be defined through a broadly participative process. Finally, regulatory norms should be subject to a cost-benefit analysis.

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152. In contrast, it is more difficult for the regulated to influence principles-based enforcement actions. *See* John T. Scholz & Feng Heng Wei, *Regulatory Enforcement in a Federalist System*, 80 AM. POL. SCI. REV. 1249, 1250 (1986) ("[The] ability [of interest groups] to influence enforcement (as opposed to rulemaking) decisions—particularly in regulatory agencies . . . is limited by case processing requirements . . . .").

153. *See* Kaplow, *supra* note 43, at 562–63 ("[S]tandards are more costly for legal advisors to predict or enforcement authorities to apply because they require later determinations of the law's content.").

154. For example, regulators may wrongly conclude that isolated misconduct is indicative of greater problems that may not exist, falling into the trap of the availability heuristic. *See* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 25–26 (2003); Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1519 (1998); Jeffrey J. Rachlinski, *Rulemaking Versus Adjudication: A Psychological Perspective*, 32 FLA. ST. U. L. REV. 529, 538–46 (2005).

155. *See* Sunstein, *supra* note 43, at 971–74.

156. *See* INTERIM REPORT ON CAPITAL MARKETS REGULATION, *supra* note 1, at 63–67.

1. *Administrative Expertise.* The first assumption of the administrative paradigm is that regulatory norms should be developed by experts.[157] Because the securities markets are complex, only specialists with experience are qualified to govern them and can assess what rules are appropriate.[158] An administrative agency such as the SEC depends on its expertise to establish its legitimacy to regulate;[159] and the SEC has such expertise because it deals with the securities industry on a constant basis—supervising registration of public offerings, inspecting brokerage firms, and encouraging investor education. Rulemaking allows experts with deep industry knowledge to carefully define regulatory norms.[160] The rules that administrative experts promulgate are part of a coherent framework that takes into consideration the holistic experience of the agency.[161]

157. *See* Grundfest, *supra* note 52, at 1018 (observing that Congress "wanted to establish an agency that would specialize in securities-related matters and build expertise not easily captured within the legislature"); Jerry L. Mashaw & David L. Harfst, *Regulation and Legal Culture: The Case of Motor Vehicle Safety*, 4 YALE J. ON REG. 257, 305 (1987) ("Delegation is justified primarily by the complexity of the regulatory tasks assigned and the need for a high level of expertise."); Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, 105 HARV. L. REV. 1511, 1518–19 (1992) (describing a New Deal theory justification of bureaucracy based on agency expertise).

158. *See* Grundfest, *supra* note 52, at 966 ("Congress created the Commission as an expert agency with the capacity to address significant problems affecting the nation's securities markets.").

159. *See* Billing v. Credit Suisse First Boston Ltd., 426 F.3d 130, 172 (2005) ("The SEC and defendants have vigilantly reminded us that the securities markets *in toto* might be better entrusted to an expert agency than to the federal courts."), *rev'd on other grounds*, 127 S. Ct. 2383 (2007); SELIGMAN, *supra* note 32, at xix ("A primary purpose of 'independent' regulatory agencies like the SEC is to allow an experienced and expert staff to resolve specific, highly technical regulatory problems."). Gerald Frug illustrates how the law legitimizes bureaucracies through a rhetoric of expertise. Gerald E. Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1276, 1322 (1984) ("The concept of administrative expertise, while not itself a 'doctrine,' is part of the rhetoric of administrative law opinions that invokes the same kind of deference to bureaucratic decisions, with the same qualifications, when made by administrative agencies.").

160. *See* Frug, *supra* note 159, at 1326 ("Administrators are 'experts'; they decide many similar cases and they presumably come from backgrounds which make them specialists; all of this produces a special knowledge in addition to the record."); Grundfest, *supra* note 52, at 967 (arguing that the SEC should apply its expertise through rulemaking defining the scope of Rule 10b-5); Thomas O. McGarity, *Some Thoughts on "Deossifying" the Rulemaking Process*, 41 DUKE L.J. 1385, 1407 (1992) ("Much modern rulemaking is highly technical in nature.").

Of course, there may be cases in which this ideal is not met and not even the agency has true expertise. *See* McGarity, *supra*, at 1398 ("Although the theoretical rationale for creating regulatory agencies is to lodge decisionmaking power in the hands of experts, the scientific and technical needs of modern informal rulemaking have in many cases outstripped the expert resources of the agencies themselves.").

The regulated might prefer regulation by experts because of the disruption that can occur when those who are perceived as nonexperts enter the scene. For example, after his investigation uncovered evidence of fraud, the New York Attorney General obtained an ex parte injunction against Merrill Lynch requiring it to implement certain measures with respect to its research practices.[162] Under the Investment Advisers Act, an investment adviser under a court injunction cannot offer investment advice.[163] Thus, the injunction could have required Merrill Lynch to shut down its investment advisory business, causing substantial economic disruption. After the SEC pointed out this possibility, the injunction was suspended temporarily.[164] This example could be used to argue that regulators who lack administrative expertise may cause significant disruption when they attempt to regulate the markets.

2. *Participative Process.* The second characteristic of the administrative paradigm is that norms should be defined through a process with procedural safeguards. Because the securities industry is so complex, even experts may make mistakes when promulgating rules. This possibility may be magnified when the conduct is in a gray area. Thus, the rulemaking process as governed by the Administrative Procedure Act requires that a rule may only be passed after the regulated and other interested parties are given notice and an opportunity to comment.[165] The notice and comment period helps

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161. *See* Frug, *supra* note 159, at 1298 ("The [bureaucratic] machine is also a highly technical and complex device, one that would be damaged by a mere layman's tinkering."); Jonathan R. Macey, *Lawyers in Agencies: Economics, Social Psychology, and Process*, 61 LAW & CONTEMP. PROBS. 109, 123–25 (1998) ("The shift to an agency process dominated by rulemaking reflected an embrace of the idea of a disinterested 'science' of rulemaking, in which quality of the decisions generated by technological sophistication triumphs over the quality of the decisions generated by the adversarial process."). In contrast, a litigation approach may not adequately mobilize broad expertise. *See* Frederick Schauer, *Do Cases Make Bad Law?*, 73 U. CHI. L. REV. 883, 916 (2006) ("[C]ase-deciding bodies may not be well situated to engage in the large-number, systematic, and empirical inquiry that effective rulemaking requires.").

162. *See* MASTERS, *supra* note 134, at 90, 92–93.

163. Investment Advisors Act of 1940, 15 U.S.C. § 80b-3(e)(4) (2000).

164. *See* MASTERS, *supra* note 134, at 93–94.

165. The Administrative Procedure Act requires agencies to give notice of "the terms or substance of the proposed rule" and "give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation." 5 U.S.C. § 553(b)–(c) (2000); *see also* Chamber of Commerce v. SEC, 443 F.3d 890, 899 (D.C. Cir. 2006) (discussing the Administrative Procedure Act's requirement that agencies give notice of a proposed rule).

regulators ensure that they are not missing considerations that militate against the adoption of the rule.[166] Part of the reason for allowing such collaboration is that the regulated may have expertise and knowledge that regulators do not.[167]

The regulated prefer an approach that allows them to mitigate rules that they perceive as unwise and unduly burdensome. Regulation FD offers an example of how the notice and comment process works. As initially written, Regulation FD applied to all company employees.[168] The regulated argued successfully through the comment process that the rule was too broad. If it were applied to all employees, mid-level employees might not be able to communicate with suppliers without worrying that they might divulge material nonpublic information. The SEC agreed and limited the reach of Regulation FD to senior management and those employees who regularly deal with research analysts.[169] Arguably, the notice and comment process prevented the promulgation of an overly broad legal norm.

After the passage of Regulation FD, the SEC went out of its way to persuade the regulated that Regulation FD would not cause undue disruption. The SEC chief of enforcement took pains to provide reassurances that "[d]espite the securities industry's outcry against Regulation FD and the flood of alarmist client letters from law firms, Regulation FD was not intended to be revolutionary."[170] This comment reflects a desire to take into account the needs of the regulated in formulating norms in order to minimize disruption. By doing so, the rulemaking approach may be taking into account the

166. *See* NLRB v. Bell Aerospace Co., 416 U.S. 267, 295 (1974) ("[R]ulemaking would provide the Board with a forum for soliciting the informed views of those affected in industry and labor before embarking on a new course."); Prentice, *supra* note 118, at 802 ("When the SEC considers new rules, it uses a process that guarantees that it will receive information and arguments from all points of view, unlike an individual decision maker prone to seeking out only information to support preexisting views."); Seidenfeld, *supra* note 157, at 1561 (arguing that rulemaking allows for greater deliberation by providing access to different views).

167. *See* Choi & Pritchard, *supra* note 154, at 24 ("Devising new regulations is costly, requiring analysis of complicated economic phenomena. Market participants are likely to know far more about these phenomena than regulators.").

168. Selective Disclosure and Insider Trading, Securities Act Release No. 7,787, Exchange Act Release No. 42,259, Investment Company Act Release No. 24,209, 64 Fed. Reg. 72,590 (proposed Dec. 28, 1999).

169. Selective Disclosure and Insider Trading, Securities Act Release No. 7,881, Exchange Act Release No. 42,43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716 (Aug. 24, 2000).

170. Walker, *supra* note 40.

political reality that the regulated may mobilize against rules they perceive are too burdensome.

3. *Use of Cost/Benefit Analysis.* A third feature of the administrative paradigm is the use of cost-benefit analysis in constructing rules.[171] Under the National Securities Market Improvement Act of 1996, the SEC is required to consider in its rulemaking process "whether the action will promote efficiency, competition, and capital formation."[172] This cost-benefit analysis requirement limits the types of norms that the rulemaking process may promulgate. Unless an agency can show that a rule is economically efficient, its power to adopt such a rule can be limited by the courts. The administrative paradigm thus envisions that proposed regulations will be assessed in economic terms.[173]

The regulated prefer a cost-benefit approach because it puts the burden on the regulator to prove a change in the status quo is necessary. The D.C. Circuit's review of rules passed by the SEC after the mutual fund scandal illustrates how this burden plays out. The D.C. Circuit struck down the rule requiring that 75 percent of a mutual fund board be comprised of independent directors.[174] It did so because the SEC had not adequately assessed the cost of the rule.[175]

B. Principles-Based Enforcement Actions and the Public Values Paradigm

The public is likely to demand that regulators move quickly against industry exploitation. When the public perceives that the

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171. *See* Macey, *supra* note 161, at 125 ("[I]n the rulemaking context, government lawyers are supposed to be weighing both the costs and the benefits of their actions when formulating rules.").

172. National Securities Market Improvement Act of 1996 § 106, Pub. L. No. 104-290, 110 Stat. 3416, 3425 (codified in scattered sections of 15 U.S.C.). Executive agencies are required to go through a more formal cost-benefit analysis under executive orders issued by President Reagan in 1981 that have essentially been ratified by other administrations.

173. The emphasis on cost-benefit analysis with respect to regulations is likely to continue. In 2006, the Committee on Capital Markets Reform recommended that the SEC should implement a formal process akin to that of executive agencies and "engage in a more risk-based process, focused explicitly on the costs and benefits of regulation." INTERIM REPORT ON CAPITAL MARKETS REGULATION, *supra* note 1, at 8, 60–62.

174. *See, e.g.*, Chamber of Commerce v. SEC, 443 F.3d 890, 908–09 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133, 144–45 (D.C. Cir. 2005).

175. *Chamber of Commerce*, 412 F.3d at 144 ("[T]he Commission violated its obligation . . . to consider the costs imposed upon funds by the two challenged conditions.").

securities markets are stacked against it, it will demand action to restore balance. Rulemaking may not meet these demands because it can be slow.[176]

Principles-based enforcement actions may allow regulators to respond to such demands. By articulating public values, such actions may decisively address public concerns.[177] A rulemaking response may be perceived as weak and ineffectual, especially if rulemaking failed to prevent the problems causing the public's outrage.[178] The principles-based enforcement actions discussed in Part II are illustrative. Renewed public interest in abusive practices may have led to *Wall Street Journal* articles that spurred investigations into abuses relating to the IPO allocation process.[179] Regulators such as the New York Attorney General responded to public outrage over high-profile scandals and the perceived ineffectiveness of the SEC by investigating industry wrongdoing.[180] Partly in response to the public sentiment, the SEC followed the lead of the New York Attorney General and became more aggressive itself. When regulators found significant evidence of wrongdoing, they acted decisively, satisfying the public's demands.

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176. *See* Kaplow, *supra* note 43, at 562 ("Rules are more costly to promulgate than standards because rules involve advance determinations of the law's content . . . ."); McGarity, *supra* note 160, at 1387 ("[I]t is difficult to disagree with the conclusion that it is much harder for an agency to promulgate a rule now than it was twenty years ago."); Ronald J. Pierce, Jr., *Two Problems in Administrative Law: Political Polarity on the District of Columbia Circuit and Judicial Deterrence of Agency Rulemaking*, 1988 DUKE L.J. 300, 301–02 ("[A]n agency realistically must conclude that making an important policy decision through the rulemaking process will require it to commit a significant proportion of its scarce resources to that process for as much as a decade.").

177. *See* Lawrence A. Cunningham, *Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative U.S.-Canada Inquiry*, 6 CANADA STEPS UP 255, 312 (2006) ("An enforcement policy should be supplemented, from time to time, by focused enforcement activity trained on publicly visible crises. These may erupt as a result of insufficiently specified underlying laws that require enforcement activity bearing a more principles-like character, although some public debacles also involve bald violation of clear rules. Either way, enforcement activities that consciously respond to public outcries are intended to promote all securities regulation's goals, of efficiency and fairness and of confidence and protection. They do so by highlighting and then exterminating behavior deemed undesirable based upon the public rebuke that provokes stepped-up enforcement.").

178. The public generally will cast aside expertise when it is perceived as ineffectual. As James Q. Wilson explains, "Americans value expertise but they do not defer to it; an expert who takes an unpopular position or acts contrary to the self-interest of an individual or group will be treated as roughly as any other adversary." JAMES Q. WILSON, BUREAUCRACY 304 (1989).

179. *See supra* note 75 and accompanying text.

180. *See supra* Part II.B.2; *see also* MASTERS, *supra* note 134, at 75–79 (discussing investigations performed by the New York Attorney General).

In contrast to the administrative paradigm, which emphasizes the use of experts, collaboration, and cost-benefit analysis, principles-based enforcement actions focus on the need to apply societal norms to industry misconduct. The conduct targeted by the principles-based actions discussed in Part II was not wrong simply because it violated NASD Rule 2110, the Martin Act, and common-law fiduciary duties. It was wrong because it violated basic principles against commercial bribery, fraud, and self-dealing embodied in those rules, statutes, and common law. These principles reflect widely accepted societal values that can only be given meaning through particular application, often referred to as "public values."[181]

The public values paradigm has three characteristics. First, regulatory norms are defined by regulators with enforcement expertise rather than administrative expertise. Second, regulatory norms are defined by a closed process rather than a participatory process. Finally, regulatory norms embody public values rather than economic values.

1. *Enforcement Expertise.* In most cases, enforcement attorneys are general experts in the litigation and investigative process rather than any particular substantive area of the law.[182] This may be especially true when state securities regulators are bringing a suit as opposed to the SEC. Even the SEC's enforcement staff do not have the day-to-day interaction with industry that staff in other divisions such as corporate finance do.[183] Moreover, enforcement actions filed

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181. The concept of public values was first articulated in the realm of constitutional law, where scholars such as Owen Fiss argued that adjudication allows courts to give meaning to the public values embodied in broad constitutional phrases. Owen M. Fiss, *The Supreme Court: 1978 Term*, 93 HARV. L. REV. 1, 2 (1979). William Eskridge applied the idea to the realm of statutory interpretation when he observed that statutes embody broad public values that should influence the way such statutes are interpreted. William N. Eskridge, Jr., *Public Values in Statutory Interpretation*, 137 U. PA. L. REV. 1007, 1036 (1989) ("[S]tatutes themselves can be the source of public values."). As Eskridge notes, it is extremely difficult to precisely define the meaning of public values. *See id.* at 1036 n.2. I do not attempt to set forth a general theory of public values with respect to securities regulation, but instead identify particular values expressed by recent enforcement actions. *See supra* Parts II.A.4, II.B.4, II.C.4.

182. *See* Macey, *supra* note 161, at 123–25 (contrasting the role of generalist lawyers in adjudication with the use of experts in the rulemaking process); Mashaw & Harfst, *supra* note 157, at 263 (noting in case study of National Highway Traffic Safety Administration that the agency was utilizing "case-by-case adjudication which requires little, if any, technological sophistication and which has no known effects on vehicle safety").

183. Of course, the Commissioners of the SEC must approve actions by the Enforcement Division.

in civil court by the SEC or state securities regulators have the potential to be decided by nonexpert judges and juries.

The enforcement process relies upon intensive fact gathering and the application of legal principles to those particular facts rather than a comprehensive study of regulatory issues. This process crystallizes the issues and focuses attention on problem areas that may not have been evident to rulemakers. The cases resulting from the application of litigation expertise may resonate more powerfully with the public than technical rules. The New York Attorney General's enforcement cases illustrate the role of generalists in defining public values. The New York Attorney General and his staff members drew on their general experience as public prosecutors and litigators rather than any particularized expertise with respect to the industry in investigating and bringing cases against research analysts and the mutual fund industry.[184] Their investigations led to examples of wrongdoing that resonated with the public and resulted in significant reform.

2. *Closed Process.* In contrast to the administrative paradigm, which is premised on broad participation in defining regulatory norms, the public values paradigm envisions a closed process with two parties, the regulator and the target. Rather than eliciting industry opinion through a notice and comment process, principles-based enforcement actions use document subpoenas and investigative testimony to elicit facts. Although the knowledge developed by principles-based enforcement does not necessarily reflect a wide range of opinions,[185] it tends to be more detailed and relevant than the information generated by the rulemaking comment process.

A closed process allows regulators to negotiate reforms in response to a particular wrong without industry interference. They can then spur change by applying reforms derived from settlements to those who committed similar types of wrongdoing. For example, in the Merrill Lynch case, as a result of specific evidence of wrongdoing by its research analysts, Merrill Lynch negotiated a settlement that

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184. *See* MASTERS, *supra* note 134, at 133–69.

185. *See* Croley, *supra* note 2, at 116 ("While the effects of adjudicatory decisions can, like rulemakings, be far reaching, adjudication processes are less open."); McGarity, *supra* note 160, at 1393 (observing that, unlike rulemaking, adjudication fails to provide for notice and comment, thus "both regulatees and regulatory beneficiaries are deprived of the open opportunity that informal rulemaking provides to influence the agencies' thinking").

established norms governing the relationship between its investment banking and research departments.[186] This settlement was the model for a global settlement involving the other major investment banking firms that implemented significant structural reforms.[187] In addition, the case helped spur rulemaking that caused significant change. Once one party agrees to a set of reforms, there is momentum that can be difficult to resist.[188]

3. *Application of Values.* Rather than using the language of cost-benefit analysis, the public values paradigm relies upon the rhetoric of values. Principles-based enforcement actions do not ask whether a legal norm is economically efficient or technically sound, but whether the conduct violates an established principle.[189] The securities laws do not just reflect economic norms. For example, Donald Langevoort observes that the insider-trading laws are partly based on "the belief in the expressive function of law generally—the idea that both law and society are better off if the law systematically expresses certain virtues."[190] Principles-based enforcement actions give meaning to the public values reflected in principles by applying

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186. MASTERS, *supra* note 134, at 102.

187. *See supra* note 115 and accompanying text.

188. This has been controversial. As the Commission on the Regulation of U.S. Capital Markets in the 21st Century reported:

> [T]he Commission repeatedly heard concerns about the SEC's use of 'undertakings' in enforcement action settlements to impose requirements that suggest industry-wide application to regulated entities. . . . [T]he concerns addressed instances in which the SEC required an undertaking in a settlement agreement that itself constituted a change in the law, which was then later applied to the entire securities industry.

COMM'N ON THE REGULATION OF U.S. CAPITAL MARKETS IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS 123 (Mar. 2007), *available at* http://www.capitalmarketscommission.com/portal/capmarkets/default.htm.

189. For example, in the context of automobile safety, Professor Mashaw and Mr. Harfst observe that issues are framed technically when rulemaking is involved, and framed in layperson's terms in enforcement cases involving defective vehicles. *See* Mashaw & Harfst, *supra* note 157, at 304 ("[T]he defects question is not framed as a technological, scientific, or economic issue. The questions are straightforward and commonsensical. Should people expect steering arms to break, wheels to collapse, or windshield wipers to fly off? Obviously not.").

Of course, there is a large body of economics literature that analyzes enforcement decisions through a cost-benefit framework. *See, e.g.*, George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526, 526–27 (1970) (arguing that society gives up complete enforcement of a rule because enforcement is costly). But as a practical matter, there are no legal standards requiring agencies to consider cost-benefit factors in deciding whether to bring an enforcement case.

190. Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1328 (1999).

them to particular situations. Principles-based regulation requires the regulated to act as moral agents who assess whether their conduct conforms with the principles reflecting those values, not just whether their conduct violates a cost-effective rule.

The language of public values can resonate more powerfully with the public than the rhetoric of costs and benefits. In contrast to the collaborative dialogue associated with Regulation FD, the New York Attorney General's rhetoric in connection with the research analyst case illustrates the public values approach. On announcing the case, the New York Attorney General stated: "This was a shocking betrayal of trust by one of Wall Street's most trusted names . . . . The case must be a catalyst for reform throughout the entire industry."[191] This approach conveys a sense that a fundamental value has been breached, not just that an economically efficient rule was violated. With such a breach, the regulator asserts authority rather than persuasion in establishing a legal norm.

C. Tension between Paradigms

Rulemaking and principles-based enforcement actions thus reflect different assumptions about the regulatory scheme and its purposes. The administrative paradigm emphasizes a predictable regulatory regime whereas the public values paradigm emphasizes the punishment of misconduct. These paradigms reflect the dualism in society's relationship with markets. Society views markets through a pragmatic, utilitarian lens, as a wealth generator that should be regulated with care. This mentality is reflected in discourse that a stable regulatory regime may make markets more attractive to foreign companies.[192] Rulemaking and the administrative paradigm fit within this vision. But society also disapproves of systematic exploitation of the public by the market. Perhaps the public reaction to the scandals uncovered by securities regulators reflects an underlying consensus that such conduct violates basic public values. To the extent that markets rely upon public confidence, there is a need to address these concerns through aggressive enforcement.

In an ideal world, these paradigms would easily coexist. Regulators would predict problem areas, promulgate cost-effective

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191. Press Release, Office of the N.Y. State Att'y Gen., Merrill Lynch Stock Rating System Found Biased by Undisclosed Conflicts of Interest: Spitzer Obtains Court Order Requiring Key Disclosure (Apr. 8, 2002), *available at* http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html.

192. *See* INTERIM REPORT ON CAPITAL MARKETS REGULATION, *supra* note 1, at 66.

rules, and companies that violate those rules would be punished. The regulated would be committed to following basic principles and those who did not would be punished. And perhaps there are times when there is such equilibrium.

Regulators certainly use both tools in responding to arguable misconduct. All of the principles-based enforcement actions discussed in Part II led to significant rulemaking. The sequence, though, makes a difference. When principles-based enforcement actions are the first response, rulemaking tends to mirror reforms implemented by the settlement terms of the principles-based enforcement action.[193] Indeed, the Committee on Capital Markets Regulation has criticized such rules as not conforming with normal rulemaking procedures.[194] In contrast, when rulemaking is the initial response, subsequent enforcement is more likely to be rules-based, not principles-based.

The reality is that there are times when there is tension between the paradigms. The rules do not anticipate significant issues and the regulated are either unaware that their conduct violates principles or simply ignore them. As a result, regulators must choose between a rulemaking response that may be perceived as deliberative but coddling industry and a principles-based enforcement response that is decisive but seen as disruptive.

To some extent, the surge in principles-based enforcement actions discussed in Part II can be seen as a temporary rejection of the administrative paradigm in favor of a public values approach. The result has been a significant amount of controversy as evidenced by the reemergence of the "Regulation by Enforcement" critique.[195] The administrative paradigm can be less disruptive than the public values paradigm because it cloaks regulation in the neutral language of administrative expertise and cost-benefit analysis. The shift from rulemaking's rhetoric of utility and cost-benefit analysis to the moral tone of enforcement actions unleashed previously repressed controversy about the shape of public values.[196] Some may argue that regulators, who are not necessarily elected, should not have the

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193. *See supra* notes 95, 151 and accompanying text.

194. *See* INTERIM REPORT ON CAPITAL MARKETS REGULATION, *supra* note 1, at 66.

195. *See supra* note 19 and accompanying text.

196. *See* Dan M. Kahan, *The Secret Ambition of Deterrence*, 113 HARV. L. REV. 413, 414 (1999) (describing the role of the deterrence idiom in muting societal conflict relating to controversial norms).

power to define those values on an ad hoc basis.[197] The subjects of principles-based enforcement actions may feel unfairly persecuted based on what they perceive is an illegitimate vision of the public good that may not be universally accepted.

IV. CHOOSING BETWEEN RULEMAKING AND ENFORCEMENT

Given the tension between the administrative and public values paradigms, how do regulators choose between rulemaking and principles-based enforcement actions in responding to arguable misconduct?[198] This Part first observes that in light of the respective preferences of the public and the regulated, public choice theory might contend that principles-based enforcement actions are more likely when public influence is high and rulemaking is more likely when the regulated have greater influence. This Part then argues that this account is incomplete because regulators are more constrained in their choices than public choice theory assumes. Even if they are constrained, regulators should counter the perception that interest

197. *See, e.g.*, Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2353 (2001) ("[A]gency experts have neither democratic warrant nor special competence to make the value judgments—the essentially political choices—that underlie most administrative policymaking."); Seidenfeld, *supra* note 157, at 1570–71 (noting risk that administrative "decisionmakers will implement their idiosyncratic conceptions of the public interest rather than society's consensus about that interest").

198. Of course, one might argue that the SEC did not really choose to bring a principles-based enforcement action in the research analyst and mutual fund cases. Rather, the SEC was pressured by the success of the New York Attorney General's approach to bring its own cases. It is difficult to know whether the SEC would have taken the same approach without the prompting of the New York Attorney General. In any event, the SEC at the very least had the discretion to follow the New York Attorney General's lead in bringing principles-based enforcement actions. And the New York Attorney General had the choice to defer to the SEC's rulemaking approach.

As noted before, under *Chenery*, it is widely accepted that administrative agencies have broad discretion in making such choices. Elizabeth Magill theorizes that courts give agencies such leeway because they can regulate the aftereffects of agency decisions. *See* Magill, *supra* note 2, at 1437 ("Courts' ability to shape some of the consequences of an agency's choice of procedure explains the continued strength of the *Chenery* principle."). This dynamic was evident in the mutual fund cases. Regulators chose to use enforcement actions to impose fines and structural reforms such as requiring that a settling mutual fund agree that 75 percent of its board would consist of independent directors. The SEC then attempted to apply the 75 percent independent director requirement to the mutual fund industry as a whole through rulemaking. *See* Investment Company Governance, 69 Fed. Reg. 3472 (proposed Jan. 23, 2004). The rule was challenged and the D.C. Circuit struck it down on the basis that the SEC had not adequately assessed the cost of the rule. *See* Chamber of Commerce v. SEC, 443 F.3d 890, 908–09 (D.C. Cir. 2006); Chamber of Commerce v. SEC, 412 F.3d 133, 144–45 (D.C. Cir. 2005).

groups drive their choices by considering certain criteria to guide their choices. Finally, this Part offers such a framework.

A. Public Choice Theory and Regulatory Choice

Many commentators have observed that there is a relationship between the business cycle and the production of securities regulation.[199] During boom times, industry has more influence, there is less public demand for regulation, regulators tend to be more cautious, and less new regulation is produced. Busts tend to reveal scandals that cause public outrage, reducing industry influence, emboldening regulators, and leading to the passage of more restrictive laws. An example of such a law is the Sarbanes-Oxley Act, which Congress passed in response to public pressure after the collapse of Enron.[200]

These arguments can be seen as a form of public choice theory, which has long been an influential framework for explaining the production of regulation. In essence, public choice theory predicts that interest groups, including industry and regulators themselves, can influence the type of regulation produced.[201] Variations of this theory predict different outcomes. The earliest form of public choice theory argued that for the most part, industries would capture regulatory agencies and that regulation would usually be produced for the

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199. *See, e.g.*, Erik F. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 396 (2006) (discussing the interplay between the business cycle, the cycle of investor confidence/investor trust, and the political economy/regulatory cycle); Joseph A. Grundfest, *Punctuated Equilibria in the Evolution of United States Securities Regulation*, 8 STAN. J.L. BUS. & FIN. 1, 1 (2002) (noting that changes in securities law have been provoked by perceived failures in the capital markets); Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 79–83 (2003) (describing the boom-bubble-bust-regulate cycle of financial market regulation). *See generally* Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849 (1997) (arguing that new technology over time has not caused new securities regulation, but rather, crashes have); Frank Partnoy, *Why Markets Crash and What Law Can Do About It*, 61 U. PITT. L. REV. 741 (2000) (using finance and legal scholarship to critique theories of why markets crash, and to make recommendations regarding what law can do about crashes).

200. Roberta Romano argues that statutes passed after periods of market turmoil often contain problematic provisions and that such statutes should provide for reevaluation at a later date. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1599–1602 (2005).

201. *See* Vivek Ghosal & Joseph Gallo, *The Cyclical Behavior of the Department of Justice's Antitrust Enforcement Activity*, 19 INT'L J. INDUS. ORG. 27, 30 (2001); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 212 (1976); George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. 3, 4 (1971). For a summary of public choice theory, see Croley, *supra* note 2, at 34–41.

benefit of the regulated.[202] Later versions were less pessimistic and observed that regulators would balance the demands of the regulated with the demands of the public.[203] Regulators are constrained in their capacity to give in to the regulated to the extent that doing so harms the public interest and their own interests. Thus, regulation can be seen as a function of balancing competing interest group preferences.

The boom/bust literature essentially links the relative influence of the regulated and public with the production of regulation. This literature, however, does not differentiate among types of securities regulation, and focuses largely on the passage of statutes by Congress.[204] The question of how interest groups can affect the choice between rulemaking and principles-based enforcement actions by securities regulators has not been examined.[205]

If one accepts the argument that the public generally prefers principles-based enforcement whereas the regulated prefer rulemaking, public choice theory might predict that regulators will be more likely to punish arguable misconduct with principles-based enforcement when public influence is high and address arguable misconduct through rulemaking when the influence of the regulated is high. When there is an economic collapse, the public may perceive that the bust is caused by industry wrongdoing. The public may press for regulatory action and regulators will respond by acting aggressively to find and punish blatant misconduct. On the other hand, when the economy is booming, the public may demand less action and the regulated will have more sway. As a result, regulators may act more cautiously and collaboratively through rulemaking.

Public choice theory might also explain the resurgence of actions by state regulators. When the influence of the regulated is high, the SEC may become captured and more likely to act slowly through rulemaking. State regulators have incentives to fill the gap by bringing aggressive principles-based enforcement actions that resonate with the public. The SEC might then be forced to respond in turn by following the lead of state regulators to regain its credibility with the public.

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202. *See* Stigler, *supra* note 201, at 3.

203. *See* Peltzman, *supra* note 201, at 212.

204. *See supra* note 199 and accompanying text.

205. *See* Magill, *supra* note 2, at 1442–43 (“There are few efforts to describe or explain how agencies choose among their available policymaking forms.”).

Over time, the public choice model would predict shifts in regulatory choice. To the extent that one group's interests are met, the other group's interests are antagonized, leading that group to mobilize to further its interests. A period of extensive principles-based enforcement actions may cause a backlash that will make regulators more cautious and shift to rulemaking responses to arguable misconduct. A period in which an overly cautious rulemaking response predominates may cause significant regulatory gaps, increasing industry exploitation of the public, leading to greater public demand for regulatory action.[206]

One can interpret the shift from rulemaking to principles-based enforcement actions as an example in which the choice of one regulatory tool led to conduct requiring the choice of a different regulatory tool. Prior to the actions described in Part II, the influence of the regulated through the "Regulation by Enforcement" critique fostered a tendency to respond to arguable misconduct through rulemaking. For various reasons, industry began acting more aggressively in areas in which rules were unclear, arguably ignoring fundamental principles.[207] As the public became more invested in the market and concerned about corporate failures such as Enron, the demand for decisive action became greater. Securities regulators became more aggressive in issuing subpoenas and uncovered abuses fostered in areas in which there were regulatory gaps. As a result, there was a shift to principles-based enforcement actions and the public values paradigm.

Public choice theory might predict that the prevalence of principles-based enforcement actions and the public values paradigm may have sown the seeds for a regulatory shift back to an emphasis on rulemaking and the administrative paradigm. The regulated have

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206. *See* John C. Coates, IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 535 (2001) (predicting that devolution of securities regulation would lead to backlash and reregulation).

207. As Joel Seligman describes:

> A widespread belief evolved in the United States financial community that time honored rules such as those that discourage conflicts of interest were quaint and easily circumvented. Too frequently, sharp practitioners in business, investment banking, accounting or law challenged the fundamental tenets of "full disclosure of material information" or "fair presentation of accounting results." A deterioration in the integrity of the corporate governance and mandatory disclosure systems occurred, not because of a novel strain of human cupidity, but because there was so much success, for so long, that some began to forget why fundamental principles of full disclosure and corporate accountability long were considered essential.

SELIGMAN, *supra* note 32, at 623.

enforcement actions described in Part II succeeded not simply because they catered to a public need, but because they uncovered documents such as e-mails detailing the wrongdoing.[213] It was this evidence that spurred the public outrage leading to substantial reforms. Regulators would point out that if they simply brought principles-based enforcement actions without such evidence, there would be little likelihood that the allegations would have a significant public impact, making it less likely that a target would feel pressure to settle the case, thereby increasing the cost of principles-based enforcement. More importantly, they would not be acting consistent with their duty as officers of the court if they brought actions without a basis.

Regulators might also point out that they do not use rulemaking simply to cater to the regulated. Rulemaking may be spurred when there is generalized evidence of a problem but no specific evidence of particular wrongdoing. In some circumstances, rules can have a more significant impact on misconduct than isolated enforcement actions. Indeed, the principles-based enforcement actions discussed in Part II may have had the greatest impact in the way that they resulted in systemic rulemaking. Moreover, regulators would object to the idea that they are simply captured by industry through the rulemaking process. Regulators would contend that their duty is to act in the public interest and that they do not blindly craft rules that favor the regulated.

Moreover, a critic of public choice theory might argue that its conception of causation is too simplistic. It is difficult to distinguish between cause and effect with respect to regulatory choices. Although public attention may spur principles-based enforcement, it may be just as likely that principles-based enforcement spurs public attention. Similarly, though industry influence may lead to rulemaking, the decision to use rulemaking may lead to industry influence.

A proponent of public choice theory might respond that although responsiveness to interest groups may not totally determine regulatory choice, it must have some impact. Despite the professionalism of regulators, it is hard to deny that the public's attention may magnify the impact of the cases they bring. For example, the actions against the research analysts may not have

213. *See* CSFB Complaint, *supra* note 16, at paras. 31–45; Canary Complaint, *supra* note 16, at paras. 59–62, 68–72, 75–76, 89, 93; Dinallo Aff., *supra* note 16, at 2, 17.

resonated as much if they had not come after a significant market meltdown. And there may be more pressure to bring questionable cases when public pressure is high. Certainly regulators have incentives to search for particular evidence of wrongdoing after periods of excess. But that does not mean that they always find it. Regardless of whether regulators are influenced by public sentiment, their actions will not have significant impact if they are based on no more than speculation.

The truth is likely somewhere in between. Regulators have greater incentives to respond to arguable misconduct by developing principles-based enforcement cases when public influence is high, but they are subject to an important constraint—they must find specific evidence of wrongdoing. In contrast, regulators may have a greater incentive to respond to arguable misconduct through rulemaking when the influence of the regulated is high, but they are subject to the constraint that they must follow procedures meant to protect the public interest.

C. A Framework for Determining Regulatory Choice

Even assuming there are meaningful constraints on regulatory choice, regulators should counter the perception that they cater to specific interests. Shifts in regulatory emphasis from rulemaking to principles-based enforcement can create instability. Although legal transitions are inevitable and perhaps no different economically than other unexpected occurrences affecting markets such as storms or recessions,[214] it can be difficult for firms to meaningfully assess the risks of regulatory shifts.[215] With the surge in principles-based enforcement actions described in Part II, there is a perception among some that the regulatory system is in disarray, with authority emanating from too many sources.[216]

The tension between the administrative and public values paradigms is at the heart of the problem. On the one hand, the

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214. Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 534 (1986) ("[T]here is little to distinguish losses arising from government and market risk. For purposes of analyzing risk and incentive issues, the source of the uncertainty is largely irrelevant. A private actor should be indifferent as to whether a given probability of loss will result from the action of competitors, an act of government, or an act of God . . . .").

215. *See* INTERIM REPORT ON CAPITAL MARKETS REGULATION, *supra* note 1, at 66 ("When new standards are introduced through specific enforcement actions and only later codified as explicit rules, confusion and distrust are likely to be the consequences.").

216. *See* MCKINSEY & CO., *supra* note 7, at 81–85.

administrative framework is meant to provide a set of cost-effective rules that the regulated can rely upon in assessing their conduct. On the other, the reality is that these rules are not perfect and that the regulated must also assess their conduct in relation to abstract principles. Because there has been little effort to synthesize these two schemes, the regulatory system seems chaotic.

But the tension between the administrative and public values paradigms should not be seen as an inevitability. There is no reason why the paradigms cannot coexist. A regulatory system can give clear notice of actionable conduct while punishing conduct that violates public values. Both rulemaking and principles-based enforcement actions serve important functions in defining regulatory norms.

Some of these concerns might be addressed by a clearer framework for assessing when a principles-based enforcement approach is appropriate. Such a framework should attempt to referee the tension between the overlapping but distinct frameworks of rules and principles. To the extent that regulators are guided by such a framework, they might mitigate concerns that they are disrupting the rulemaking regime mainly in response to public pressure. Moreover, if regulators have clearer guidance as to when it is appropriate to use a principles-based enforcement action, they can act decisively when the proper situation arises, reducing the risk of agency capture.

Such a framework should be synthetic, in that it balances the concerns of the administrative paradigm—fair notice, collaboration, and cost-effective norms—with the concerns of the public values paradigm—confrontation of wrongdoing that violates fundamental values. Regulators should consider four criteria in determining whether principles-based enforcement or rulemaking is appropriate in responding to arguable misconduct.

First, is the principle to be applied in the absence of a clearly applicable rule well established, or is it novel? If the principle is well established, then the fair notice concerns of the administrative paradigm might be addressed. Moreover, the conduct would more likely implicate the fundamental values that are part of the public values paradigm. If the principle is novel, then fair notice concerns become more significant and the conduct may be less likely to violate values on which there is societal consensus.

Second, is the issue raised by the misconduct addressed by existing rules, or is there an inadvertent gap in the rules that has been exploited? If the rulemaking process envisioned the alleged misconduct and decided it should not be prohibited, then the regulated may be entitled to rely upon the judgment of the rules framework. On the other hand, if the rulemaking process simply failed to envision the issue and the regulated are merely exploiting a gap, there may be less of a need to refrain from punishing the conduct with a principles-based enforcement action.

Third, is there particularized evidence of wrongdoing, or is there only generalized evidence of wrongdoing? If there is particularized evidence establishing the wrongdoing, there may be a greater case for choosing a principles-based enforcement action, but if the evidence of wrongdoing is more generalized, rulemaking might be more appropriate.

Fourth, is the public harmed in a significant way by the misconduct? Did the wrongdoer know that the misconduct would cause public harm? If misconduct has minimal effects on the public, the case for punishing the misconduct with a principles-based enforcement action is weaker. If the misconduct causes significant public harm and the wrongdoer is aware the conduct will cause harm, the case for confronting such wrongdoing with a principles-based enforcement action is stronger.

To illustrate this synthetic framework in a more concrete way, I apply it to five possible scenarios of arguable misconduct (these are not meant to be exhaustive):

(1) conduct violates a principle set forth in a rule;
(2) conduct violates both a rule and a principle;
(3) conduct is in an area that is unregulated by rules, does not violate a rule, but violates a principle;
(4) conduct is in an area that is heavily regulated by rules, does not violate a rule, but violates a principle; and
(5) conduct is sanctioned by a rule but violates a principle.

The case for choosing a principles-based action in response to arguable misconduct is strongest in situation (1) and weakest in situation (5).

1. *Conduct Violates a Principle Set Forth in a Rule.* When conduct violates a principle set forth in a rule, it is more likely that the principle is well established and the regulated should be aware that they will be subject to that principle. Thus, the case for a principles-based enforcement action can be strong.

The primary example of a principle embodied by a rule is the anti-fraud principle set forth in SEC Rule 10b-5.[217] There is broad societal agreement that fraud harms the public because it leads to inefficient markets and is morally reprehensible.[218] Because the principle has been applied in a wide variety of cases over time, courts have been able to create limitations governing anti-fraud actions. Those limits include the requirement that wrongdoers act with scienter, or recklessness, in order for liability to attach, as well as that the fraud is material, or likely to affect the decision of a reasonable investor.[219] Because the anti-fraud principle has been defined by both rulemaking and adjudication, it is the quintessential example of a well established principle.[220]

Moreover, when a principle is embodied in a rule, it is more likely that actions enforcing the principle are consistent with the regulatory scheme. For example, although there are rules that exhaustively detail the types of information a company must disclose for a securities offering,[221] anti-fraud actions can also be brought targeting misrepresentations and omissions not covered by those rules. No one argues that these actions somehow disrupt the rules governing the disclosure process.

The case for bringing a particular anti-fraud action turns on whether there is specific evidence of such fraud. The case against Merrill Lynch for fraudulent misstatements by research analysts was a fairly straightforward application of the anti-fraud principle. There was specific and powerful evidence from which fraud could be reasonably inferred. Although Merrill Lynch may have been able to argue with the characterization of the facts, if the allegations were true and research analysts knowingly misrepresented the prospects of companies, such conduct contravened a well established principle

217. 17 C.F.R. § 240.10b-5 (2007).

218. *See, e.g.*, Ackerman v. Schwartz, 947 F.2d 841, 847 (7th Cir. 1991) ("The optimal amount of fraud is zero.").

219. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976).

220. Of course, there is always room for more clarity with respect to the standard of liability. *See* INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION, *supra* note 1, at 12, 80 (arguing that the SEC should further define the elements of Rule 10b-5).

221. 17 C.F.R. pts. 210, 228.

contained in a rule. Thus, there was a strong case for a principles-based enforcement action.[222]

2. *Conduct Violates both a Rule and a Principle.* When conduct violates both a rule and a principle, the case for a principles-based enforcement action can also be strong. Even if the principle is not well-defined, if the conduct independently violates a rule, the wrongdoer has notice that the conduct is prohibited. Moreover, it may be likely that if the conduct is condemned by both a rule and a principle, the application of the principle is in accord with existing rules. The principle and rule working in tandem may provide a strong case for condemning certain conduct. Of course, the decision will likely hinge on the strength of the evidence establishing misconduct as well as whether the conduct caused public harm.

The CSFB case is an example of an instance in which conduct violated both a rule and a principle. The quid pro quo arrangements in which CSFB traded a share in IPO profits for kickbacks arguably violated NASD Rule 2330(f), which prohibits profit sharing arrangements.[223] But if that had been the only violation, there may not have been sufficient justification for a $100 million sanction. NASD Rule 2330(f) was meant to protect consumers and no consumers were directly harmed. The conduct not only violated the text of a specific rule, it also violated a broader principle against bribery in commercial transactions.[224] The rule and the principle in this case worked in tandem. NASD Rule 2330(f) explained why the conduct was technically wrong, the anti-commercial bribery principle explained why the conduct was fundamentally wrong and was punished so harshly. The evidence of quid pro quo arrangements was specific and strong, and there was an argument that such commercial bribery tainted the public markets. Thus, there was a case for a principles-based enforcement action.

3. *Conduct Is Unregulated by a Rule but Violates a Principle.* A more difficult case is when conduct occurs in an area that is unregulated by rules but violates a principle. In such circumstances, the regulator will have to carefully assess whether the violated

222. The question of the appropriateness of the structural reforms that resulted should be addressed in a separate paper.

223. *See supra* note 77 and accompanying text.

224. *See supra* notes 88–89 and accompanying text.

principle is well established and whether the lack of rules is deliberate or just an inadvertent gap. The regulated might argue that the fact that there is no rule indicates that regulators have sent the message that the conduct will be unregulated.[225] The regulated may argue that in such cases, the arguable misconduct should be excused and rulemaking used to prohibit the conduct going forward. As with all cases, the decision to proceed by principles-based enforcement actions in such circumstances will rely heavily on the specificity of the evidence and the extent of public harm.

The mutual fund cases fit within this scenario. There were no rules regulating market timing but the existence of market timing arrangements may have violated fiduciary duty principles.[226] One could argue that the application of fiduciary duty principles was novel. Although the idea that investment advisers were fiduciaries was long established, there was relatively little precedent for aggressively enforcing these duties through principles-based enforcement.[227] Of course, there was also an anti-fraud theory. Mutual funds publicly proclaimed that they prohibited market timing to their investors while secretly and knowingly allowing some investors to do it in exchange for compensation. Although there were no rules specifically prohibiting market timing arrangements, there is no indication that this gap was a deliberate part of the regulatory scheme. There was clear evidence of market timing arrangements in e-mails.[228] Moreover, mutual funds were clearly aware that these market timing arrangements hurt investors because of their policies prohibiting market timing.[229] In sum, there was a strong case that principles-based enforcement actions were an appropriate response to market timing arrangements.

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225. *See* SEC v. Pimco Advisors Fund Mgmt. LLC, 341 F. Supp. 2d 454, 471 (S.D.N.Y. 2004) (noting that defendant "seeks to avoid liability by asserting what may be considered the 'everyone was doing it' defense; since secret market timing arrangements were widespread in the industry . . . [the defendant] seems to suggest that he cannot be charged with violating his own fiduciary duties towards his investors").

226. Of course, there was a rule prohibiting late trading. *See* 17 C.F.R. § 270.22c-1 (2007). But that rule did not address the issue of market timing.

227. *See* Lori A. Richards, Dir., Office of Compliance Inspections & Examinations, SEC, Speech to the Eighth Annual Investment Adviser Compliance Summit, Wash., D.C.: Fiduciary Duty: Return to First Principles (Feb. 27, 2006), *available at* http://www.sec.gov/news/speech/spch022706lar.htm.

228. *See* Canary Complaint, *supra* note 16, at paras. 76, 89.

229. *See id.* at paras. 34, 74, 84–85, 92, 94; *see also supra* note 142 and accompanying text.

4. *Conduct Is in an Area Heavily Regulated by Rules but Violates a Principle.* The case for using a principles-based enforcement action may be more controversial when the conduct is in an area heavily regulated by rules, does not violate a rule, but violates a principle. In such a case, one might make an argument similar to the rationale for the implied immunity doctrine, which immunizes actors from antitrust liability when there is a clear repugnancy between the securities laws and antitrust principles.[230] But the analogy is not perfect because a securities law principle is more likely to be in accordance with the underlying system of rules than an antitrust principle.

Accounting fraud cases often fit this scenario. Accounting decisions are made pursuant to technical rules that are arguably comprehensive. Yet that has not precluded principles-based enforcement actions when there is specific evidence of wrongdoing violating a well established principle. The decision by Judge Henry Friendly in *United States v. Simon*[231] is illustrative. In that case, the defendants, who were auditors, argued they could not be found guilty of participating in a financial fraud if the financial statements complied with Generally Accepted Accounting Principles (GAAP). The district court judge instead instructed the jury that the "'critical test' was whether the financial statements as a whole 'fairly presented the financial position of [the audited company]'" and that although compliance with GAAP was persuasive, it was not conclusive in establishing good faith.[232] Judge Friendly approved the charge, holding that compliance with GAAP did not excuse the accountants from complying with the greater principle that "an accountant is under [a] duty to disclose what he knows when he had reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for

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230. *See* Credit Suisse Sec. (USA) LLC v. Billing, 127 S. Ct. 2383, 2392 (2007). Clear repugnancy is determined through consideration of four factors:

> (1) the existence of regulatory authority under the securities law to supervise the activities in question; (2) evidence that the responsible regulatory entities exercise that authority; and (3) a resulting risk that the securities and antitrust laws, if both applicable, would produce conflicting guidance, requirements, duties, privileges, or standards of conduct. . . . (4) . . . the possible conflict affect[s] practices that lie squarely within an area of financial market activity that the securities law seeks to regulate.

Id.

231. United States v. Simon, 425 F.2d 796 (2d Cir. 1969).

232. *Id*. at 805–06.

the private benefit of its president."[233] Under *Simon*, it appears that principles-based enforcement actions relating to accounting may be appropriate when there is clear evidence that the accountant's inaction, although not violating GAAP, violates the accountant's fundamental duty to disclose certain types of material self-dealing.[234]

5. *Conduct Is Sanctioned by a Rule but Violates a Principle.* The case for a principles-based enforcement action is weakest when the conduct is sanctioned by a rule but arguably violates a principle. In such a case, even if the principle is well established, the application of the principle would not be in accordance with the underlying regulatory scheme. Such a situation likely raises the same concerns addressed by the implied immunity doctrine, which immunizes conduct when there is a "clear repugnancy" between the regulatory system and liability standard,[235] and applying the principle would lead to "duplicative and inconsistent standards."[236]

An example is the scrutiny of "soft dollar" payments made by institutional investors such as mutual funds to brokers. As discussed earlier, only a portion of the commission for a stock transaction pays for the actual execution of the transaction. Part of the commission is understood as paying for research and other services. Section 28(e) of the Securities Exchange Act expressly permits this practice.[237] After the regulatory attention of the market timing scandals, there was renewed scrutiny of "soft dollar" payments. There were reports that "soft dollar" payments were being used not only to pay for research, but other expenses such as computers, overhead, and tickets to sporting events.[238] Although such payments might violate certain fiduciary duty principles, Section 28(e) might be fairly read to allow such practices. Because the application of the fiduciary duty principle to such conduct would be novel and not in accordance with the regulatory scheme, a principles-based enforcement action might not

233. *Id*. at 806.

234. And the "fairly presents" principle has been codified by Sarbanes-Oxley. *See* Sarbanes-Oxley Act of 2002 § 906(a), 18 U.S.C. § 1350 (Supp. V 2005).

235. *See Credit Suisse Sec. (USA) LLC*, 127 S. Ct. at 2391.

236. *Id.* Of course, the "implied immunity" standard has not been applied to bar liability based on the securities laws, and I do not mean to imply that it should, but the concept is useful in analyzing the interaction between rules and principles.

237. *See* Securities Exchange Act of 1934 § 28(e), 15 U.S.C. § 78bb(e) (2000).

238. *See, e.g.*, Christopher Oster & Tom Lauricella, *Mutual Funds' Soft Fees Getting a Hard Look*, WALL ST. J., Dec. 26, 2003, at C1.

be appropriate. Consistent with this approach, the SEC has addressed the issue by providing interpretative guidance with respect to the scope of Section 28(e).[239]

Regulators should be cognizant, though, of attempts to falsely characterize conduct as being sanctioned by rules. One example is the case of Enron and its treatment of Special Purpose Vehicles (SPVs). Enron's argument for the legitimacy of these SPVs was that an independent entity had a 3 percent ownership interest in the SPVs, and thus they could be treated as off Enron's balance sheet. Enron's argument implied that there was a 3 percent rule under GAAP under which it could account for SPVs in this way. But there was no such rule. As William Bratton explains, the purported rule derived from a 1991 letter from the SEC accountant, which "never intended three percent to be taken as a one-size fits-all test."[240] Indeed, "[s]ince 1991, the SEC has insisted repeatedly that there is no three percent test . . . ."[241] Thus, the argument that such conduct is immune from attack by principles-based enforcement actions falls flat.

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Public choice theory might predict that regulators choose between principles-based enforcement actions and rulemaking based on the relative influence of the public and the regulated. Although the choice is certainly influenced by the economic and social climate, regulators are constrained in their choice by the type of evidence they uncover. The challenge of choosing between principles-based enforcement and rulemaking is synthesizing the concerns of the administrative and public law paradigms. In making this choice, regulators should consider whether the principle they are enforcing is novel or well established, whether the principle is in accord with existing rules, whether there is compelling evidence establishing the wrongdoing, and whether the public is harmed.

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239. Indeed, the SEC published guidance on the scope of Section 28(e) in 2006. *See* Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Release No. 34–54165, 71 Fed. Reg. 41,978 (July 24, 2006).

240. William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1043 (2003).

241. *Id.*

CONCLUSION

At first glance, securities regulation appears to be comprised of two incompatible competing paradigms. The collaborative approach of the administrative paradigm at times does not fit with the confrontational approach of the public values paradigm. The result, it seems, is a system oscillating arbitrarily between accommodating rulemaking and disruptive principles-based enforcement actions. The resurgence of principles-based enforcement actions has given rise to renewed criticisms of "Regulation by Enforcement." Public choice theory would argue that these aggressive enforcement actions are merely a response to greater public influence in the wake of a market collapse.

But although the economic climate can create greater incentives for regulators to punish questionable behavior, the regulatory response is not just determined by politics. In all of the major enforcement actions described in this Article, regulators uncovered specific evidence of conduct that did not violate a specific rule but transgressed a well established principle in ways that harmed the public and the market. Regulators must construct a compelling case of misconduct that violated fundamental public values, or rulemaking will be the appropriate response.

Despite these constraints, regulators should do more to synthesize the values embodied by the administrative and public values paradigms. The regulatory scheme should embody both predictability and a concern for public values. In deciding how to respond to arguable misconduct, regulators should carefully consider whether the principle they are enforcing is well established, whether its application coheres with existing rules, whether there is compelling evidence of misconduct, and whether the conduct targeted caused foreseeable harm to the public. By doing so, regulators can take a meaningful step toward harmonizing a system that relies on both specific rules and general principles.