

# Bringing Financial Services Regulation into the Twenty-First Century

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A gracious good evening to you.

I am pleased to help celebrate the twenty-fifth anniversary of the *Yale Journal on Regulation*. Over the past twenty-five years, the *Yale Journal on Regulation* has published hundreds of thoughtful articles on a wide array of regulatory issues—such as airline<sup>1</sup> and telecommunications<sup>2</sup> deregulation, consumer protection,<sup>3</sup> and pesticide regulation.<sup>4</sup> It fills a very vital and necessary niche for regulatory aficionados like me. Looking back, however, the *Journal's* earlier years evince a limited focus on corporate law and governance and securities regulation—areas near and dear to my heart. There have been several on banking topics by my very good friend and colleague, Deputy Dean Jonathan Macey,<sup>5</sup> three on governance and securities topics by Professor Roberta Romano,<sup>6</sup> and even one, way back when, that I co-authored,<sup>7</sup> as well

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1 See, e.g., Robert W. Crandall & J. Gregory Sidak, *Is Structural Separation of Incumbent Local Exchange Carriers Necessary for Competition?*, 19 YALE J. ON REG. 335 (2002); Michael E. Levine, *Why Weren't the Airlines Regulated?*, 23 YALE J. ON REG. 269 (2006).

2 See, e.g., Alfred E. Kahn, *Deregulation: Looking Backward and Looking Forward*, 7 YALE J. ON REG. 325 (1990); Howard A. Shelanski, *Adjusting Regulation to Competition: Toward a New Model of U.S. Telecommunications Policy*, 24 YALE J. ON REG. 55 (2007); J. Gregory Sidak, *The Failure of Good Intentions: The WorldCom Fraud and the Collapse of American Telecommunications After Deregulation*, 20 YALE J. ON REG. 207 (2003).

3 See, e.g., Ian Ayres & Matthew Funk, *Marketing Privacy*, 20 YALE J. ON REG. 77 (2003); Michael S. Barr, *Banking the Poor*, 21 YALE J. ON REG. 121 (2004).

4 See, e.g., Joseph Frueh, Comment, *Pesticides, Preemption, and the Return of Tort Protection*, 23 YALE J. ON REG. 299 (2006).

5 See, e.g., Jonathan R. Macey & Elizabeth H. Garrett, *Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215 (1988); Jonathan R. Macey & Geoffrey P. Miller, *Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities*, 12 YALE J. ON REG. 1 (1995).

6 Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119 (1992); Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174 (2001); Roberta Romano, *The Political Dynamics of Derivative Securities Regulation*, 14 YALE J. ON REG. 279 (1997).

as a smattering of others. But the bulk of the *Journal's* attention has been focused on other important areas.

In the last several years, that has changed, with four corporate law-related articles in the last four issues.<sup>8</sup> With the current focus on the functioning (or malfunctioning) of our markets and appropriate ways to regulate them, the interest of scholars in this area will likely continue. I hope regulators and legislators will take that scholarship into account in formulating and revising our regulatory structure, a regulatory structure in desperate need—as they say on TV—of an extreme makeover!

I am pleased to be back in New Haven, a city brimming with significant American history. Tomorrow the town celebrates the 208th anniversary of Powder House Day. That was the day—it actually was April 23, 1775—following news of the defeat of British regulars at Lexington and Concord, when troops of the Governor's Foot Guard, garrisoned at New Haven, demanded access to a local powder house to arm themselves and join their Massachusetts brethren. The troops, under Capitan Benedict Arnold's command, were not fazed by a vote of the town's selectmen the prior day that had denied aid to the Massachusetts forces. Arnold demanded access to the powder house; when he was refused, he said he would break in and take what his troops needed. Local authorities relented; Arnold and his men got their ordnance and marched off to become early Revolutionary War participants.<sup>9</sup>

Tonight I would like to discuss a different revolution brewing in our financial regulatory environment—one of great consequence and in the news lately. Stresses and currents roiling our financial and capital markets are not quite as profound as those that pushed America to war with England. But stresses and currents there are, and as they occur, regulatory structures must—but do not always—change and adapt. These structures risk eroding into irrelevance, sweeping away entirely, or impeding free flows of capital and economic growth. Unfortunately, we are plagued by all of these results.

U.S. financial services regulation dates back a century and a half. In 1863 Congress passed the National Currency Act<sup>10</sup>—precursor to the National Bank Act<sup>11</sup>—to create and regulate a national bank system under the aegis of the Office of the Comptroller of the Currency. In doing so, Congress left in place

7 Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149 (1990).

8 Sharon Hannes & Omri Yadlin, *The SEC Regulation of Takeovers: Some Doubts from a Game Theory Perspective and a Proposal for Reform*, 25 YALE J. ON REG. 45 (2008); Madoka Mori, *A Proposal to Revise the SEC Instructions for Reporting Waivers of Corporate Codes of Ethics for Conflicts of Interest*, 24 YALE J. ON REG. 293 (2007); Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structure for a Race to the Top*, 24 YALE J. ON REG. 313 (2007); Jeffrey Y. Wu, *Revisiting Business Roundtable and Section 19(c) in the Wake of the Sarbanes-Oxley Act*, 23 YALE J. ON REG. 249 (2006).

9 Bill Ryan, *Benedict Arnold, Hometown Bad Boy*, N.Y. TIMES, Aug. 10, 1997, at 13CN.

10 National Currency Act, ch. 58, § 37, 12 Stat. 665 (1863).

11 National Bank Act (codified as amended in scattered sections of 12 U.S.C. (2000)).

the long-established system of state regulation of commercial banks, creating a two-tiered system of banking regulation. In 1871 the National Association of Insurance Commissioners formed to coordinate regulation of interstate insurers by individual state insurance commissions.<sup>12</sup> In 1945 the Supreme Court held that insurance was interstate commerce subject to federal regulation;<sup>13</sup> Congress promptly nullified that decision and perpetuated the existing system of fragmented, state-by-state, insurance regulation by adopting the McCarran-Ferguson Act.<sup>14</sup>

In the wake of the Great Depression, Congress embraced the construct of independent regulatory agencies as a way to deal with perceived dysfunctions in our financial and capital markets. In the first 100 days of the New Deal, Congress passed the Glass-Steagall Act, created the Federal Deposit Insurance Corporation, and mandated separation of commercial and investment banking.<sup>15</sup> It passed the Securities Act,<sup>16</sup> and later the Securities Exchange Act,<sup>17</sup> establishing the Securities and Exchange Commission (SEC) and concentrating federal regulatory authority over securities trading, securities markets, and securities professionals. But it explicitly preserved existing common law and state regulatory provisions and remedies.<sup>18</sup>

In light of this evening's focus on the role of scholarship in government regulation of industry, the passage of the 1933 and 1934 Acts, and the creation of the SEC pursuant to the 1934 Act, interestingly illustrate how not to use academia, and academics, to craft regulatory structures. Those laws were not drafted by a thoughtful, multidisciplinary team drawing expertise from academics and real world practitioners, based on the results of carefully designed economic studies. Instead, they were drafted by two young attorneys—Thomas Corcoran and Benjamin Cohen—and an even younger Harvard Law professor—James Landis—based largely on their own academic theories and some undisciplined Senate Banking Committee hearings.<sup>19</sup> These draftsmen, while brilliant, had no scholarly or practical experience in what they were about to regulate.

After passing these seminal acts, Congress enhanced the SEC's statutory powers, pausing in 1940.<sup>20</sup> Three decades later, it created the Securities

12 See National Association of Insurance Commissioners, About the NAIC, [https://www.naic.org/index\\_about.htm](https://www.naic.org/index_about.htm) (last visited May 5, 2008).

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

14 McCarran-Ferguson Act, § 15 U.S.C. 1011 (2000).

15 Banking Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 32, 48 Stat. 162 (1933).

16 Securities Act of 1933, 15 U.S.C. §§ 77a – 77mm (2000).

17 Securities Exchange Act, 15 U.S.C. §§ 78a – 78mm (2000).

18 See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 36-40 (3d ed. 1998).

19 *Stock Exchange Practices: Hearings Before the Comm. on Banking and Currency*, 73d Cong. 6556 (1934).

20 The SEC was given additional jurisdiction pursuant to the Public Utility Holding Company Act, the Trust Indenture Act, the Investment Company Act and the Investment Advisers Act. See

Investor Protection Corporation,<sup>21</sup> followed four years later by the Commodity Futures Trading Commission.<sup>22</sup> This half-century of federal legislative activity yielded at least fifty-one regulators for insurance companies,<sup>23</sup> fifty-seven for commercial banks<sup>24</sup> and fifty-three for investment banks,<sup>25</sup> not counting commodities, credit union and allied regulators. We are blessed—or cursed—with federal regulatory bodies, self-regulatory bodies, private-sector regulatory bodies, individual and multiple state regulatory bodies, local regulatory bodies and global regulatory bodies, each struggling to define its role and justify its existence, often bestowing duplicative or conflicting regulations.

Until recently, services and products provided by investment bankers were distinct from services and products offered by commercial banks which, in turn, bore little resemblance to those of insurance companies. The compartmentalized regulatory system mirrored the contours of the financial services landscape. Starting with the New Deal (and even before), each new regulatory initiative, with its related agency and volumes of regulations, was aimed at particular market players that had exclusive rights to market specific products. Market participants were regulated based on birth, not substance!

This balkanized regulatory regime may have made sense when it developed, but the tangled regulatory structure was, and remains, ill-suited to control the waves of new financial products that began in the 1970s with the advent of money market mutual funds. They recently may have crested with the meltdown of the subprime market, with its exotic and complex synthetic financial instruments. To the extent legacy regulatory systems retained any vestiges of viability, they were swept away by the Gramm-Leach-Bliley Act (GLB).<sup>26</sup>

GLB repealed Glass-Steagall, removing an artificial barrier between commercial and investment banking; it opened the floodgates for consolidation of financial services and financial service providers, along with a torrent of new products. Unfortunately, it deliberately left in place the existing patchwork of federal and state regulatory agencies and regulatory regimes.<sup>27</sup> The political

Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 N.Y.U. J. INT'L L. & POL. 931, 1000 n.287 (2003).

21 The Securities Investor Protection Corporation was created pursuant to the Securities Investor Protection Act, 15 U.S.C. § 78ccc(a)(1) (2000).

22 The Commodity Futures Trading Commission was created pursuant to the Commodity Exchange Act, 7 U.S.C. § 2 (2000).

23 See National Association of Insurance Commissioners, 2008 Membership List, [http://www.naic.org/documents/members\\_membershipist.pdf](http://www.naic.org/documents/members_membershipist.pdf) (last visited Mar. 27, 2008).

24 U. S. GEN. SERV. ADMIN., 2008 CONSUMER ACTION HANDBOOK (2008), available at [http://www.consumeraction.gov/pdfs/2008\\_Handbook\\_Web\\_Version.pdf](http://www.consumeraction.gov/pdfs/2008_Handbook_Web_Version.pdf).

25 *Id.*

26 The Gramm-Leach-Bliley Act was enacted under the name Financial Modernization Act of 1999, 15 U.S.C. §§ 6801-09 (2000).

27 That system recently was characterized as “stovepiping” and “nearly irrelevant to today’s market” by SEC Chairman Christopher Cox. Damian Paletta & Kara Scannell, *Politics & Economics: Washington Revisits Financial Regulation*, WALL ST. J., Mar. 21, 2008, at A6.

fallout from trying to change the regulatory structure was just too much to handle along with the historic deconstruction of barriers to commerce.

Today's financial world is, well, worlds away from the one in which the U.S. regulatory system developed. It is a world in which financial products are fungible, financial services are ubiquitous, financial transactions are electronic, and the effects of financial activities are global. It is a world in which our regulatory system continues to be so redundant, overlapping, and discontinuous that it stifles innovation, discourages informed and prudent risk-taking, promotes inefficiency, encourages regulatory arbitrage and, ultimately, incentivizes domestic firms and capital to go offshore, and foreign firms and capital to avoid U.S. markets.

Modern U.S. financial services firms have, of necessity, developed in mirror image to the antiquated regulatory structure in which they function—with different business groups for products and services under the purview of each regulator. The organizational infrastructure necessary to support these multiple groups results in inflated overhead, redundancy, and internal inefficiency—and that is true as well for our regulatory structure.

According to a number of recent studies, this leaves us with capital markets losing their competitive edge to international competitors.<sup>28</sup> And, as the recent meltdown of the subprime market and Bear Stearns's collapse indicate, it leaves us with poorly understood areas of the market that need neither more nor less regulation, but rather smarter regulation. In short, we have a regulatory and legal system exemplifying the age-old story of the blind men and the elephant. At best, each regulator understands and addresses the discrete area that it regulates, without fully understanding the surrounding landscape or the relationship of one area to another. At worst, regulators do not fully understand what they regulate, causing some areas to receive attention from multiple regulators while other areas escape all regulatory consideration.

The system cries out for serious change, which begs the question: Where do we go from here? Addressing that question requires us to return to first principles. The most fundamental principle is that transparent and well-

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28 The Committee on Capital Market Regulation (the "Paulson Committee") was formed by Secretary of the Treasury Henry Paulson in September 2006. The Paulson Committee delivered its interim report—*The Interim Report of the Committee on Capital Markets Regulation*—on November 30, 2006, and its final report—*The Competitive Position of the U.S. Public Equity Market*—on December 4, 2007 (the "Paulson Committee Report"). See COMM. ON CAPITAL MKTS. REGULATIONS, THE COMPETITIVE POSITION OF THE U.S. PUBLIC EQUITY MARKET (2007), available at <http://www.capmksreg.org/>. New York Mayor Michael Bloomberg and Senator Charles Schumer (D-NY) commissioned a report on the position of the U.S. and New York in global capital markets from McKinsey & Company. See MCKINSEY & CO., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP (2007), available at [http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special\\_reports/2007/NY\\_REPORT%20\\_FINAL.pdf](http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf). The U.S. Chamber of Commerce formed the Commission on the Regulation of U.S. Capital Markets in the 21st Century in 2006. It issued its and recommendations in March 2007. See COMM'N ON THE REGULATION OF U.S. CAPITAL MKTS. IN THE 21ST CENTURY, REPORT AND RECOMMENDATIONS (2007), available at <http://www.capitalmarketscommission.com/portal/capmarkets/default.htm>.

regulated capital markets outperform those that aren't transparent or well-regulated. Notice I did not say "unregulated" and I did not say "over-regulated."

Capital is the lifeblood of innovation. Alas, it also is finite. Thus, one key to building effective financial market regulatory systems is permitting unimpeded movement of capital to its most effective uses. This means minimizing the number of regulators and regulations. Financial markets are increasingly global, and the U.S. is not any longer their focal point. U.S. and foreign investors can invest in either U.S. or foreign companies, so there is international competition for every investment dollar.

Competitors for investments should compete under comparable ground rules. If not, some competitors may gain unfair advantages. Significant disparities in regulatory constraints and requirements across markets will encourage competitors subject to higher standards to evade them by non-compliance or by relocating to less regulated markets. In the other direction, regulators trying to maximize the attractiveness of their markets may adopt or modify rules to encourage capital flows in directions they otherwise might not travel. Known as regulatory arbitrage, this distorts financial markets and undermines efficiency.

Regulatory opportunism most likely occurs, and has significant impact, across international borders where, all other things being equal, regulators feel less constrained to strive for a modicum of uniformity. Of course, all other things are rarely equal, and they are not equal in the competition for capital across international borders. So another key component of effective market regulation is for regulators of financial markets to be cognizant of the global effects of regulation. Put another way, within constraints of disparate cultures, we must strive for regulatory regimes comparable to, and compatible with, those in place internationally.

This recalls another basic principle—namely that global markets, governed by global regulators, require global accommodations. The SEC recently has taken steps in the right direction, dropping its longstanding requirement that foreign private issuer filers reconcile financial statements prepared under International Financial Reporting Standards (IFRS) to U.S. Generally Accepted Accounting Standards.<sup>29</sup> The SEC is looking to take another step in that direction, and away from U.S. geocentricism, by considering whether to allow U.S. issuers to prepare their financial statements under IFRS.<sup>30</sup>

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29 Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Accounting Standards without Reconciliation to U.S. GAAP, Securities Act Release No. 33-8879, Exchange Act Release No. 34-57026, 73 Fed. Reg. 986 (Jan. 4, 2008).

30 Concept Release on Allowing U.S. Issuers to Prepare Financial Statements In Accordance with International Financial Reporting Standards (Corrected), Securities Act Release No. 33-8311, Exchange Act Release No. 34-56217, 72 Fed. Reg. 45,600 (Aug. 14, 2007).

If these are the relevant principles, how do we apply them to reach a workable solution? On a macro level, the right move will take us toward a principles-based and prudential regulatory system, and away from the prescriptive approach that some U.S. regulators slavishly follow. For example, the United Kingdom's Financial Services Authority (FSA) uses a principles-based approach, applying a risk-based, cost-benefit analysis to ensure that proposals that do not deliver benefits exceeding their costs will not advance beyond the drawing board. And while the FSA has the authority to pursue firms that do not follow its rules, it is not compelled to pursue every violation.<sup>31</sup>

Conversely, SEC regulations, and those of most U.S. financial regulators, are prescriptive and run to tens, hundreds or even thousands, of pages. In setting standards for humanity, God articulated the operative principles in ten easy-to-remember rules, placed on just two stone tablets. Yet, federal and state regulators fell thousands of trees every year to print their constantly multiplying litany of prescriptive requirements. Not only is it irrational to expect market participants to decipher, digest and apply thousands of pages of opaque, turgid prose, but requiring participants to do so is a significant reason for problems currently facing our capital markets.

The SEC got religion in the aftermath of the financial debacle known as Sarbanes-Oxley Act (S-Ox) Section 404. After years of outrage from regulatees over compliance costs, the SEC issued guidance, in the form of a moderately sized and generally helpful interpretive release, setting out a risk-based, top-down approach to management's required annual evaluation of internal control over financial reporting.<sup>32</sup> Reporting companies now have principles-based rules that mesh with the parallel rules applicable to their auditors<sup>33</sup>—something to be applauded and emulated. Not only must regulation become more principles-based and less prescriptive, it also must be rationalized by creating an overarching federal regulatory system that would decrease, if not eliminate, burdens of duplicative, overlapping and conflicting regulation, and ensure that all financial services regulation is viewed through the prism of an effective principles-based approach.

To achieve this, a joint private-public body should be convened, under the Treasury's auspices, to design the new structure, with the goal of an efficient, liquid and transparent provision of financial services and products, and with an appropriate balance between efficiency and consumer/investor protection. Treasury Secretary Paulson initiated this kind of thoughtful review with the formation of his Committee on Capital Markets Regulation in September

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31 See, e.g., Clyde Mitchell, *Regulatory Reorganization: A Chance for Change?*, N.Y. L.J., Feb. 13, 2008, at 3.

32 Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Securities Act Release No. 33-8810, Exchange Act Release No. 34-55929, 72 Fed. Reg. 35,324-43 (June 27, 2007).

33 The SEC coordinated its guidance with that issued by the Public Company Accounting Oversight Board to public company auditors in the form of Auditing Standard No. 5. *Id.* at 35,334-35.

2006,<sup>34</sup> and more recently with the publication of his *Blueprint for a Modernized Financial Regulatory Structure*.<sup>35</sup> In November 2006 the Committee issued an interim report, with recommendations regulators could adopt in the near term.<sup>36</sup> Late last year the Committee issued a new report, which it called “a second wake-up call,” noting that “not nearly enough ha[d] been done” due to a lack of “commitment and political leadership.”<sup>37</sup>

Secretary Paulson’s *Blueprint*, on the other hand, has generated more heat than light. Some label it an attempt to reduce the amount of necessary regulation Wall Street must endure. There is much in the *Blueprint* I commend to you. There is also much I disagree with. What I do not question, however, is the *Blueprint*’s motivation. It is the first, but surely not the last, word. It recognizes that our financial services system is broken and needs overhauling. My concern with it is its forecast that it will take a decade, if not more, to complete that overhaul. If our system is not working—as Bear Stearns’s meltdown proves—it must be fixed now. In the interim, regulators writing the principles need to keep their regulatory mission firmly in mind. The SEC’s, mission, for example, is not just to protect investors, but also to facilitate capital formation.<sup>38</sup> As it currently operates, the SEC takes a highly legalistic approach toward regulation, causing it to miss the reasons for existence.

An unfortunate result of its reliance on legal, as opposed to economic, analysis is that the SEC often imposes additional obligations without disciplined consideration of the costs of its mandates, or whether existing rules could be revised to meet perceived needs, with less disruption, at lower costs. When regulators put pen to paper, they should recall it is always cheaper for government to implement a new rule than it is for the regulated to comply.

The five years of experience under S-Ox Section 404 is instructive. When S-Ox passed, the SEC estimated aggregate annual compliance costs at \$91,000 per company.<sup>39</sup> Studies put the actual cost at \$3 million and more.<sup>40</sup> A “miss” of this magnitude is inexcusable. Indeed, if a public company had “missed” this badly in its projections, the SEC would charge deliberate fraud! In addition, any rules should be considered “provisional.” The end of rulemaking should not be the adoption of the rule. Rather, the end of the process should be a

34 See COMM. ON CAPITAL MKTS. REGULATION, *supra* note 28.

35 DEP’T OF THE TREASURY, *BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE* (2008), available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

36 COMM. ON CAPITAL MKTS. REGULATIONS, INTERIM REPORT (2006), available at [http://www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf).

37 DEP’T OF THE TREASURY, *supra* note 35, at v.

38 U.S. Securities & Exchange Comm’n, *The Investor’s Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 24, 2008).

39 Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 33-8238, Exchange Act Release No. 34-47986, Investment Company Act Release No. IC-26068, [2003 Transfer Binder] Federal Sec. L. Rep. (CCH) ¶ 86,023 (June 5, 2003).

40 MCKINSEY & CO., *supra* note 28, n.97.



revisitation of the rule after a reasonable period of time to assess how much it costs, how effective it has been, and whether the specific rule has violated the law of unintended consequences.<sup>41</sup>

At present, the SEC performs economic analyses because it must, not because it wants to. This is not a surprise, given the paucity of economists on the SEC's staff. At the end of last year, out of 3400 SEC employees, 25 were economists, and the Commission's Office of Risk Management was populated by two souls—an economist and an accountant.<sup>42</sup> These are the folks supposedly looking out for the forest, while everyone considers the trees. In light of its functions, and the rapidly evolving state of our capital markets, the atrophied state of the SEC's economic analytical capacity is problematic. A steady flow of relevant information is the lubricant that permits markets to function effectively. If data is generated and available, market participants can and, assuming economic rationality, will, make decisions without needing regulatory intervention.

In carrying out its mission, the SEC should shuck its erroneous view that it is an enforcement agency with regulatory powers and start acting like a regulatory agency that also has enforcement powers. A fundamental goal of regulation is defining appropriate standards and facilitating compliance with them. By the time the SEC brings an enforcement action, the damage usually already has occurred. It is more effective to induce compliance with law in the first instance than to utilize the club of enforcement after the fact to punish those who have violated the law. One way to achieve compliance is to include those subject to regulation in the regulatory process, by encouraging them to ask questions and vet proposed products, services, and activities in advance of implementation, rather than leaving market participants to guess at the legality of their plans and prosecuting them if they guess wrong.

Finally, and this is may be anathema to some, our government must be strong enough to abandon regulations that don't work or have outlived their usefulness. A way to do this is to include sunset provisions in all regulations. Imposing such provisions would firmly focus decisionmakers on the relevant regulatory issues, provide incentives to keep them focused and ensure inertia does not set in. However, this approach has a number of problems. Of course, given the vast number of regulations in place, it is not realistic to expect that all rules will be retrofitted with sunset provisions. More importantly, it is unlikely that, when considering new rules, regulators will consistently pick an appropriate sunset period. Even with sunset provisions, some regulations will

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41 Robert K. Merton, *The Unanticipated Consequences of Purposive Social Action*, 1 AM. SOC. REV. 894 (1936).

42 The SEC had a total of 3455 full-time employees as of December 31, 2007. See United States Securities and Exchange Commission, Commercial and Inherently Governmental FTE Inventory Worksheet, <http://sec.gov/about/fair2007.pdf> (last visited Mar. 27, 2008). According to unpublished figures provided by the SEC staff, as of December 31, 2007, the staff included 25 economists, 940 accountants, 8 law clerks, 1396 attorneys, and 132 securities examiners.

outlive their usefulness and others will be extended at the end of their terms. And, of course, knowing human nature, sunset provisions might result in automatic renewals rather than careful reconsiderations.<sup>43</sup>

H.L. Mencken once proclaimed that “all government is evil, and trying to improve it is largely a waste of time.”<sup>44</sup> I don’t share that dismal a view. I believe, though, that regulators and legislators habitually respond to crises by promulgating rules or statutes without sufficient or well-focused study, frequently imposing ill-thought-out, costly, unnecessarily burdensome and ineffective requirements. Of course, while a number of high-profile observers have embraced the view that restructuring of the regulatory framework for our financial markets is needed,<sup>45</sup> it is also useful to recall the observation, often attributed to Will Rogers, that “we should be glad we’re not getting all the federal government that we’re paying for.”<sup>46</sup> Any reevaluation and restructuring of our regulatory scheme must limit the burdens of regulation, while providing necessary tools to avoid undermining its effectiveness.

Thank you.

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43 Indeed, in 1968, the SEC adopted “temporary” rules to implement the provisions of the so-called Williams Act, which gave the SEC the power to regulate takeovers, among other things. Those temporary rules remained on the SEC’s rulebooks for over two decades, before they were ultimately finalized. See Harvey L. Pitt, *On the Precipice: A Reexamination of Directors’ Fiduciary Duties in the Context of Hostile Acquisitions*, 15 DEL. J. CORP. L. 811, n.178 (1990).

44 See Anoop Rathod, *Where’s the Love*, DARTMOUTH INDEP., Apr. 24, 2006, <http://www.dartmouthindependent.com/archives/2006/04/wheres-the-love.html>.

45 Henry Paulson, Secretary of the Treasury, Remarks to the U.S. Chamber of Commerce Capital Markets Competitiveness Conference (Mar. 26, 2008), available at <http://online.wsj.com/article/SB120654176431365471.html>.

46 See, e.g., Policy of Liberty, Quotes, <http://www.policyofliberty.net/quotes1.php> (last visited Mar. 27, 2008).

