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# Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience

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# Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience

Donald C. Langevoort

## Abstract

Politics aside, the question of whether the EU should create an SEC is about the trade-offs between scale and accountability. This paper considers that trade-off in the U.S. context, with specific attention the SEC's apparent role as a "global" securities regulator on matters relating to issuer disclosure. The principal claim is that in making enforcement decisions, there will likely be a "home bias" toward domestic enforcement actions that makes extraterritorial actions less likely, thus reducing the incentives to comply. To the extent that this is typical of regulatory behavior, then there may be lessons for Europeans considering the question of institutional design. More broadly, the paper also considers some of the institutional features that make SEC enforcement policy what it is, which may or may not be exportable (or which policy makers in Europe may not want to import) to the European context

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Much of the rich policy debate in Europe over the appropriate structure of securities regulation focuses on whether there should be a "European SEC,"[1] and is largely about the trade-offs between scale and accountability. Scale has to do with the regulatory authority needed to respond coherently to the needs of issuers and investors in an integrated European capital market and facilitate the building of globally competitive market mechanisms. Here, the argument favors a large-scale regulator because investment and capital market activity in Europe long ago moved beyond the national level and the regulatory issues clearly cross all European borders.

The natural fear, however, is that as regulatory authority scales upward, regulatory accountability diminishes. Part of this is purely political – member countries lose control over securities law policy by ceding it to a centralized authority, and hence the ability to favor or protect particular interests or constituencies. This has fed lengthy debates over sovereignty and subsidiarity in the context of EU economic integration, perhaps mainly by countries that sense more to lose than gain from true integration.[2] But there is a serious normative concern. The choice of a single "monopolist" regulator raises the risk that the regulatory choices will diverge from the

[1] E.g., Gerard Hertig & Reuben Lee, *Four Predictions About the Future of EU Securities Regulation*, 3 J. Corp. L. Stud. 359 (2003); Yannis Avgerinos, *The Need and the Rationale for a European Securities Regulator*, in FINANCIAL MARKETS IN EUROPE: TOWARDS A SINGLE REGULATOR (Andenas & Avgerinos, eds, 2003); Gilles Thieffry, *The Case for a European Securities Commission*, in REGULATING FINANCIAL SERVICES AND MARKETS IN THE 21ST CENTURY (Ferran & Goodhart, eds., 2001); Eddy Wymeersch, *Regulating European Markets: The Harmonisation of Securities Regulation in Europe in the New Trading Environment*, in REGULATING FINANCIAL SERVICES, supra, at 189. From a U.S. perspective, see Eric Pan, *Harmonization of U.S.-EU Securities Regulation: The Case for a European Securities Regulator*, 34 Law & Pol'y Int'l Bus. 499 (2003); Roberta Karmel, *The Case for a European Securities Commission*, 38 Colum. J. Trans. L. 9 (1999).

[2] Although the Lamfalussy procedure moves the coordination process toward greater speed and efficiency, it did not recommend a centralized regulator. Hiamh Moloney, *The Lamfalussy Legislative Model: A New Era for the EC Securities and Investment Services Regime*, 52 Int'l & Comp. L.Q. 509 (2003). The tone in much of the literature on the appropriate structure of EU securities regulation is pessimistic about whether the politics make such discussion even realistic, though Hertig and Lee, supra, predict some progress. My aim is simply to contribute to the normative discussion, without any reference to political realism.

objectives that by most accounts should drive securities regulation: efficiency and (to many, at least) fairness. Hence the interest in systems promoting issuer choice and regulatory competition so as to discourage and limit the effects of inefficient regulation.

None of this is unique to Europe, of course. Academics in the U.S. have for some time explored alternative structures to the scope of securities regulation that would shift authority away from the SEC back to the states, to other countries or to private (or semi-private) structures such as stock exchanges and alternative trading systems.[3] The common assumption of the critics is that the SEC behaves inefficiently too much of the time because of its imperialistic jurisdiction. Their proposals are serious and powerful, although they have gained little political traction even among the likely beneficiaries.[4]

My paper is an exploration of both scale and accountability in U.S. securities regulation, with the hope that some of the lessons may translate well for purposes of European policy-making. It does not try to resolve the ultimate comparative question of the desirability of regulatory consolidation versus competitive fragmentation: that ultimately involves the empirical question of how well market mechanisms can substitute for the loss of regulatory control through either efficient pricing of risk or the development of private institutions for investor self-protection, and there is insufficient consensus about that.[5] My focus instead is an exploration of the status quo

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[3] E.g., Stephen Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. Cal. L. Rev. 903 (1998); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L.J. 2359 (1998); Paul Mahoney, *The Exchange as Regulator*, 83 Va. L. Rev. 1453 (1997).

[4] See John Coates IV, *Private vs. Political Choice in Securities Regulation: A Political Cost/Benefit Analysis*, 41 Va. J. Int'l L. 531 (2001); see also Frederick Tung, *From Monopolists to Markets?: A Political Economy of Issuer Choice in International Securities Regulation*, 2002 Wisc. L. Rev. 1363 (2002). On the relevance to the European question, see Howell Jackson, *Centralization, Competition and Privatization in Financial Regulation*, 2 Theoret. Inq. L. 649 (2001).

[5] E.g., James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 Colum. L. Rev. 1200 (1999).

– how the SEC deals with the scale it has, and what institutional forces make it more or less accountable for how it performs.

The specific issue addressed here, which has interesting implications for Europeans along a number of dimensions, involves the SEC's credibility as a "global" securities regulator. Much as been made in both the law and finance literature about the so-called "bonding hypothesis" – that firms in countries with insufficient investor protection choose to cross-list their securities in U.S. markets so as to submit voluntarily to SEC jurisdiction and hence commit to investors that they will obey a higher legal standard.[6] The implicit assumption (though not a necessary one) is that the SEC enforces its regulation proportionately with respect to both domestic and foreign issuers. Recent high-visibility actions by the Commission in Parmalat and other European scandals would seem to bolster that credibility, which the SEC surely wants to encourage.[7]

My hypothesis, however, is that there is a significant "home bias" in securities regulation, just as there appears to be in the portfolios of most investors.[8] That is to say, scarce regulatory resources are expended in a discriminatory way, with disproportionately less being devoted to extraterritorial enforcement. A limited body of empirical evidence supports such a bias toward domestic enforcement; one aim for this paper is to

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[6] See John C. Coffee, *Racing Toward the Top?: The Impact of Cross Listings and Stock Market Competition on International Corporate Governance*, 102 Colum. L. Rev. 1757 (2002); G. Craig Doidge et al., *Why are Foreign Firms that are Listed in the U.S. Worth More?,* J. Fin. Econ. (forthcoming, 2004); G. ANDREW KAROLYI, THE WORLD OF CROSS LISTINGS AND CROSS LISTINGS OF THE WORLD: CHALLENGING CONVENTIONAL WISDOM (Ohio St. U. working paper, Feb. 23, 2004). The question of whether or to what extent the bonding hypothesis is the best description of the data is contested. For a thoughtful speculation on the feasibility of "piggybacking" on another regulatory regime, see Bernard Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. Rev. 781, 816-19 (2001).

[7] See Michael Schroeder & Silvia Ascarelli, *Global Cop – New Role for SEC: Policing Companies Beyond U.S. Borders*, Wall St. J., July 30, 2004, A-1.

[8] E.g., Joshua Coval & Tobias Moskowitz, *Home Bias at Home: Local Equity Preferences in Domestic Portfolios*, 54 J. Fin. 2045 (1999); Gur Huberman, *Familiarity Breeds Investment*, 14 Rev. Fin. Stud. 659 (2001); Karen Lewis, *Trying to Explain Home Bias in Equities and Consumption*, 37 J. Econ. Lit. 571 (1999). Explanations abound for the home bias, some rational, others behavioral.

explain, within a broader exploration of agency accountability, why it is likely to be a robust phenomenon that says something important about international securities law.

If the bias is robust, there are lessons for European policy-makers. First, any temptation to justify a lesser-scale European securities regulator because assertive US regulation compensates for any lingering European gaps would be misguided. Second, my suspicion would be that a home bias would not be unique to the U.S. but rather a common feature of comparative securities regulation. If that is so, then the exercise shows the risk for the EU in relying on a system of country-by-country regulation that is not fully integrated. In the face of a home bias, regulation is unlikely to be applied efficiently to cases where the impact is diffusely multi-national, a phenomenon likely to become more and more common as international securities markets evolve.

I also have a more general aim in this study, whether or not the home bias claim succeeds. Those who either favor or reject the idea of a European SEC sometimes use the U.S. SEC as an archetype for what they want or don't want. The implicit assumption is that the performance of the SEC would be replicated in its European counterpart. But that is likely only if the many institutional features that make the Commission what it is are successfully transplanted. A study of how the Commission makes enforcement decisions can shed light on the agency as an institution, showing just how much transplantation would be required for those who admire the SEC enough to want replication, and what might be altered in the institutional context of a European SEC for those wanting different outcomes.

### A. THE PRIMACY OF ENFORCEMENT

Like all forms of regulation, securities law involves a combination of standard-setting and enforcement.[9] In much of the academic literature on international securities regulation, the former is highlighted and the latter almost relegated to status as a given – it simply presumes that countries enforce what their laws say. This, however, is unrealistic because it ignores the role of limited resources and enforcement discretion (and hence potential bias) in policy implementation, especially when the prevailing standards tend toward ambiguity. On a global scale, a well-known example is in the area of insider trading.[10] In the last decade or so, more than a hundred countries have adopted laws that largely mimic those found in the EU or the U.S., with local variations. As written, many are quite impressive, often far more coherent than the patchwork found in the U.S. A study by Bhattacharya and Daouk, however, demonstrated that there is little or no positive market reaction to the adoption of these laws measured by changes to the cost of capital in domestic markets.[11] Only when the country in question begins to demonstrate a credible enforcement commitment (which is fairly rare) does the market begin discounting the risk of insider trading opportunism.

Public securities law enforcement is an intriguing phenomenon, in part because it occurs as seldom as it does. In the U.S., the seemingly aggressive SEC brings only 500-600 enforcement proceedings each year, of which roughly 25% deal with financial reporting and general issuer disclosure.[12] This in a universe of some 17,000 reporting companies, not to mention the thousands of broker-dealers, investment advisers and others

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[9] On the enforcement process, see Ralph Ferrara & Philip Khinda, *SEC Enforcement Proceedings: Strategic Considerations for When the Agency Comes Calling*, 51 Admin. L. Rev. 1143 (1999).

[10] A forceful exploration of this is Barry Rider, *Policing the International Financial Markets: An English Perspective*, 16 Brook. J. Int'l L. 179 (1990).

[11] Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. Fin. 75 (2002); UTPAL BHATTACHARYA & HAZEM DAOUK, WHEN NO LAW IS BETTER THAN A GOOD LAW (SSRN, June 2004).

[12] See James D. Cox et al., *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 Duke L.J. 737 (2003).

within the Commission's jurisdiction. In turn, the vast majority of these enforcement proceedings are settled, meaning that the sanctions imposed are often diluted (if not eliminated nearly entirely, as in many cease and desist proceedings) to strike a deal that obviates the need for costly litigation. Historically, this paucity of enforcement has been seen as the product of severely limited resources. Although the SEC's budget has been increased recently, the amount of the increase still pales compared to the scale of the regulatory task unless one assumes that some other high-powered institutional forces are also strongly at work.

As a result, the Commission staff needs to leverage its resources.[13] For example, it chooses cases carefully for their publicity value, because a front page story creates more salience for the enforcement program than a score of cases that get minor coverage or none at all, even though the severity of the harms may well be the same. The staff's inclination to settle nearly all its cases reflects the view that the publicity associated with numerous settlements, in which the defendants at least cannot deny the wrongdoing and agree to some sanction, is worth far more than one or two hard fought victories in court – not to mention the risk of a well-publicized defeat instead of victory.

Of course direct enforcement is not the only mechanism that exists to induce compliance. Private lawsuits outnumber SEC enforcement actions, though cases are limited to those settings where there is sufficient economic incentive to sue. Compliance is also accomplished by enlisting "gatekeepers" such as bankers, lawyers and accountants.[14] The standard idea here is that these repeat players have liability and reputational incentives to thwart impropriety by their clients, though some of the impact

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[13] See *Major Human Capital Challenges at SEC and Key Trade Agencies: Hearing Before the S. Subcomm. On Oversight of Gov't Mgt, Restructuring and the District of Columbia, Comm. on Governmental Affairs*, 107th Cong. (2003).

[14] John C. Coffee, *Understanding Enron: It's About the Gatekeepers, Stupid*, 57 Bus. Law. 1403 (2002); Reinier Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J. L. Econ. & Org. 53 (1986).

probably comes simply because when the number and diversity of decision-makers forced to become involved in a particular setting increases, a fraudulent conspiracy becomes that much harder to launch.[15] Moreover, the SEC is adept at harnessing the self-interest of professionals: lawyers, for example, benefit considerably from the perception of substantial enforcement risk and can be expected, on average, to inflate that threat to their clients.[16] In this way, enforcement risk may be amplified.

My point here is only that the Commission allocates its scarce enforcement resources very carefully, and in the next section we will consider how it makes those decisions. For now, what is important is the consequence, which is there will be something of an acoustic separation between the standards that are set and the way those standards are actually enforced. The recent financial reporting scandals and the Sarbanes-Oxley Act offer a good example on the domestic side. As many have pointed out, most all of the substance of the Act (and resulting SEC rules) relating to corporate disclosure practices is an elaboration of standards that were latent in existing law but simply not enforced.[17] The CEO/CFO certification requirement probably imposes little greater liability risk than had been present for a long time in light of the signature requirements for 10-K's and 10-Q's, but the SEC did very little to impose supervisory responsibility on senior officers prior to the scandals.[18] Similarly, the open-ended narrative required by the Management Discussion & Analysis could always have been read to require disclosure of nearly any "likely" material event necessary to understand why the current financials might not be a good

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[15] See Neal Katyal, *Conspiracy Theory*, 112 Yale L.J. 1307 (2003).

[16] See Donald C. Langevoort & Robert Rasmussen, *Skewing the Resuls: The Role of Lawyers in Transmitting Legal Rules,* 5 So. Cal. Interdiscip. L.J. 375 (1997).

[17] E.g., Lawrence Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and it Just Might Work*), 35 Conn. L. Rev. 915 (2003).

[18] See Lisa Fairfax, *Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes Oxley Act*, 55 Rutgers L. Rev. 1 (2002).

predictor of future performance – a disclosure obligation well beyond how the requirement was actually enforced, at least until Enron and Worldcom.

Even the most controversial of the Sarbanes-Oxley standards, the internal reporting controls provision,[19] is an extension of an under-enforced predecessor with its own statutory origins. In the aftermath of corporate and political corruption scandals in the 1970's, Congress enacted the Foreign Corrupt Practices Act of 1978, which in part requires public companies to keep "accurate" books and records and have a system of internal accounting controls necessary to assure that corporate assets are properly overseen. Potentially – and probably as intended – it was a major statutory incursion into corporate governance. But within a few years, the Commission signaled that it had no intention of enforcing the law to the letter, and relegated internal controls to a lesser subject of regulatory attention until the recent scandals.[20]

The point, then, is that "regulation by enforcement" is the norm in the U.S. and should be a focus of any analysis of regulatory strategy. That is not in the spirit of former SEC Commissioner Roberta Karmel's criticism of the Commission for subtly *expanding* its jurisdiction through enforcement instead of rulemaking,[21] but rather with respect to the many ways in which the Commission has more or less consciously chosen *not* to be as aggressive as it might.

### B. THE INFLUENCES ON SEC ENFORCEMENT DISCRETION

A theory of how the SEC exercises its discretion is helpful not just to predict the likelihood of a home bias in enforcement but more generally

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[19] See Michael Alles & Srikant Datar, *How Do You Stop the Books from Being Cooked? A Management-control Perspective on Financial Accounting Standard Setting and the Section 404 Requirement of the Sarbanes-Oxley Act*, 1 Int'l J. Discl. & Governance 119 (2004).

[20] Exchange Act Rel. No. 17500 (Jan. 29, 1981).

[21] ROBERTA KARMEL, REGULATION BY PROSECUTION (1981).

for those (as in Europe) who are contemplating the trade-offs between scale and accountability involved in the creation of a pan-European regulatory agency. Unfortunately, while political science offers some tools of interest – e.g., capture theory, public choice models[22] – none is well accepted enough empirically or nuanced enough to offer robust predictions about the SEC in its particularized institutional context. Indeed, differences of opinion about what constitutes "the public interest" in securities regulation means that there is no agreed-upon baseline against which even to test for systematic departures.

What does seem clear is that securities regulation has a fairly stable base of political support in the U.S., weakening only during strong bull markets. This is not necessarily the product of widespread public influence, at least directly. Except in times of serious perceived scandal – of which the U.S. has probably had only two, once in the 1930's and again briefly in 2002 – retail investors have demonstrated relatively little political clout. Commonly, the external influences on regulation have been more organized: lawyers, the securities industry, the business community, etc. More recently, organized labor, state officials, and state and private pension fund managers have emerged as additional forces with which the SEC must reckon (or with which it can ally).

Within this disparate group of organized interests, there has developed some consensus on the desirability of securities regulation at its core: mandating some basic disclosure, and sanctioning clear-cut instances of fraud.[23] After all, most securities regulation is just a solution to the economists' lemons problem, and firms (both issuers and those in the securities industry) on the more legitimate end of the scale appreciate a

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[22] See SUSAN M. PHILLIPS & J. R. ZECHER, THE SEC AND THE PUBLIC INTEREST (1981); David Haddock & Jonathan Macey, *Regulation on Demand: A Private Interest Model With an Application to Insider Trading*, 30 J. L. & Econ. 311 (1987); Coates, supra.

[23] See ANNE KHADEMIAN, THE SEC AND CAPITAL MARKETPLACE REGULATION: THE POLITICS OF EXPERTISE 174 (1992)(examining the politics of support for the SEC enforcement mission).

mechanism that helps separates out the lemons from the rest of the fruit. Investor confidence generates wealth for those who supply the relevant goods.[24] The support wanes mainly when the subject of regulation or enforcement is more ambiguous in its utility. The history of U.S. securities regulation suggests that aggressive enforcement has often *increased* during more conservative administrations – perhaps to mask deregulation that is occurring in the regulatory arena.[25] But it is almost always enforcement against behavior that can be portrayed as horribly sour. For example, the SEC received much credit in the 1980's, during the Reagan and Bush administrations, for its aggressive insider trading campaign against the likes of Ivan Boesky, Michael Milken, Dennis Levine and so on. Whatever ones views of the merits, this was a group that could easily be marginalized as "bad apples" – something which many in the business community were especially happy to see in light of the close connections between the people and firms involved and the facilitating of aggressive corporate control transactions.[26]

It is tempting to describe a form of "regulatory capture" here, though I do not find the concept particularly helpful as applied to the SEC. It is a familiar problem of pluralism: there are too many well organized interests with conflicting agendas for any one to securely effectuate a capture – the business community shares some goals with Wall Street but is completely antagonistic on others, while the states, unions and pension funds have very different interests. The better image is one of an SEC that regularly bargains with all these groups in the way it chooses to exercise discretion, sometimes conferring favors on one or another to gain something

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[24] Whether an excess of confidence can be a bad thing for investors is the subject of Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 Tex. L. Rev. 777 (2000).

[25] See Donald C. Langevoort, *Managing the Expectations Gap in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 Vill. L. Rev. 1139 (2003).

[26] For a criticism of the aggressiveness, see DANIEL FISCHEL, PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION (1995).

in return. As John Coates has pointed out, for example, the Commission has demonstrated a remarkable willingness to accommodate industry interests in such areas as the adoption of private offerings under Regulation D, the shelf registration process, and Rule 144A (thereby creating a large sphere of deregulated or unregulated capital raising transactions).[27] But at the same time each of those concessions is marked by limitations that would not exist were industry demand the only explanation behind them.[28] Much more is going on.

The capture idea is further muddied in light of the extraordinary influence of the legal profession on the Commission.[29] Lawyers dominate the SEC staff, with most senior staff (and commissioners) having a relatively short tenure. This has led some to speculate that there is an agency cost problem here: senior officials will trade concessions to private interests in return for future job or client prospects. Two problems, however, make this problematic. First, the broad consensus among officials needed for significant action makes it hard for one or a handful of officials to push policy in the direction of a particular interest. Second, the dominating strategy for opportunistic officials may be instead to create some new body of regulation that is dense and difficult to interpret or apply, and upon departure claim the rents associated with expert informational advantage. That may lead to more regulation rather than less. The same can be true in the enforcement area: the most feared enforcers are in high demand to shift sides because of their external reputations and credibility with members of the Commission staff who remain behind. To the extent

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[27] See Coates, *supra*.

[28] For example, as much a benefit as Rule 144A has turned out to be, especially in the international sphere, it was heavily criticized initially as too restrictive to do much good. In all these deregulatory initiatives, the Commission has made an effort to retain bureaucratic control over the public markets – and designed the initiatives so as not to threaten the public franchise the Commission has gained.

[29] See HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979).

that there is lawyer capture, in other words, it will have a diffuse pro-regulatory bias difficult to square with a simple theory of industry capture.[30]

Lawyers aside, a public choice model is somewhat more plausible, especially in light of the support among the organized interests for a significant baseline of securities enforcement – the amount necessary to signal a credible commitment to exposing and removing the lemons. It is entirely possible that decisions dealing with matters beyond this baseline are largely the products of bargaining with affected interest groups, the outcomes of which will vary with the shifting political landscape and resource needs at any given moment. However, the assumption behind this is an anthropomorphic conception of the SEC as unified rational actor, rather than a bureaucracy. Shift the focus to the bureaucratic nature of the Commission and staff (something beyond the mere fact that five commissioners are involved in formal agency decisions[31]) and the inquiry changes considerably.

The SEC as a bureaucracy is something of a "black box" that has not yet been opened and systematically explored.[32] To me, an interesting project would be to borrow from an increasingly rich body of work in institutional economics that emphasizes the adaptive role that internal culture plays in organizations[33] to try to predict what features we might

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[30] Perhaps the one place where lawyer capture does seem to have diminished the Commission's fervor is in enforcement actions against lawyers. After a period of saber-rattling in the 1970's, the Commission nearly ceased its enforcement activity against lawyers, depriving it of a mechanism for leveraging enforcement resources via a gatekeeper strategy. The Sarbanes-Oxley Act has created the appearance of a step-up in the threat against the profession, though it would probably be premature to predict long-lasting aggressiveness in Commission enforcement in this area.

[31] All formal actions of the SEC are by majority vote at a meeting at which a quorum of commissioners is present. However, the Chairman has executive control over the agency's budget and staffing, and thus has a higher level of working control over the agency.

[32] See Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric and the Process of Policy Formation*, 47 Wash. & Lee L. Rev. 527 (1990); KHADEMIAN, supra, at 1-5.

[33] E.g., Benjamin Hermalin, *Economics and Corporate Culture*; Robert Cooter & Melvin Eisenberg, *Fairness, Character and Efficiency in Firms*, 149 U. Pa. L. Rev. 1719 (2001); Danny Miller, *The Architecture of Simplicity*, 18 Acad. Mgt. Rev. 116 (1993).

expect in a bureaucracy like the SEC. One idea on which this work builds is that cultures operate as a coordination device. In any setting in which coordinated action is necessary among large number of individuals, the "cognitive environment" must be simplified lest there be endless disagreement among agency actors, which leads to paralysis. By contrast, when there is a shared cultural understanding on key issues, the possibility of productive activity increases. In turn, there is also a motivational element here: to the extent that productive activity consonant with shared beliefs does occur, it legitimates and reinforces the belief system in a way that strengthens the commitment of the actors involved. (Lack of productive activity consistent with these beliefs, on the other hand, is demoralizing – something that the SEC has faced from time to time).

To say that cultures play an adaptive role does not give us any clue as to the content of that cultural understanding, and it is important not to romanticize something like the SEC role as "the investor's champion" (its motto) as a cultural imperative. But I do think that that self-image is has some traction, especially in the hands of SEC chairmen sensitive enough to tend to it. My prediction is that one would find within the Commission staff a belief system that (a) overestimates the amount of venality and opportunism among business people; (b) underestimates the sophistication of retail investors and the checks on overreaching created by markets and institutions; and therefore – importantly – (c) overestimates the importance of law (and hence the role of the Commission) in creating marketplace integrity.[34] (To be clear, I think there is ample venality in the business community insufficient investor sophistication, and that law is important – it's simply that those impressions are over-amplified within the SEC culture). A corollary of (c), in turn, is an inflated sense of the contribution

[34] Certain of these are extensions of predictable psychological biases, a point emphasized in Stephen Choi & Adam Pritchard, *Behavioral Economics and the SEC*, 56 Stan. L. Rev. 1 (2003).

that SEC enforcement makes in marketplace integrity. While Commission staff members are well aware of the size and resources of market participants (indeed, take some "David versus Goliath" pride in the inequity) they believe that they are at least holding their own, and making progress. Maintaining such a belief system to the greatest extent possible is what makes coordination and motivation possible. When doubts creep in – as happened in the 1980's when faith in market efficiency rose in a way that called the SEC's mission seriously into question – the culture turns fragile and matters are opened for renegotiation in ways that diminish productivity.

How might this admittedly abstract portrayal of agency culture affect SEC enforcement choices? Again, I will assume the commitment to the core objective of combating abject securities fraud (significant investment scams, market manipulations, corrupt deceit) when discovered. Beyond that, however, my prediction would be that enforcement choices reflect a balance of attentiveness to the often conflicting demands of the influential constituencies noted earlier and the need to signal a continued commitment to the mythology. Elsewhere, for example, I have argued that the SEC's long standing crusade against insider trading – to which it has devoted time and attention arguable disproportionate to the economics of the phenomenon – is as much symbolic as substantive.[35] Insider trading cases (especially those involving high status actors) are highly salient, evoking emotional responses from the public that increase the visibility and legitimacy of the SEC's mission. It is an effective form of "branding" U.S. style securities regulation. To that I would add an internal dimension as well: it is an equally effective way of demonstrating a consistent commitment to the mythology that enables productive activity. Here again the 1980's crusade against M&A based insider trading on Wall Street is a perfect illustration. It came at a time of serious doubt within the agency

[35] Donald C. Langevoort, *Rereading* Cady, Roberts: *The Ideology and Practice of Insider Trading Regulation*, 99 Colum. L. Rev. 1319 (1999).

about the legitimacy of other aspects of securities regulation (especially mandatory disclosure mechanisms), which were at the time the subject of significant deregulation. In many ways, the stepped-up aggressiveness was compensatory, and not just for public consumption.

The foregoing has emphasized a strategic dimension to the choice of enforcement cases, with special attention to the need to leverage scarce enforcement resources. A separate problem is the identification of cases in the first place.[36] The SEC staff and their counterparts at the self regulatory organizations do some real-time surveillance with respect to market manipulation and insider trading, and inspections in the form of both periodic visits of securities firms and "sweeps" do occur and can lead to enforcement. But the most serious cases of abuse are typically hidden from plain view and come to the attention of the staff only after the fact, when someone "blows the whistle." Actual whistle-blower reports are possible, though the Commission's responsiveness to unverified complaints has been questioned. Short-sellers are also common sources of information of potential wrongdoing, though again the motives here are mixed. In fact, a surprisingly large number of SEC enforcement actions come about simply because the staff reads the financial press: journalists' report on some evidence of fraud or impropriety, and the staff is interested enough to follow up with at least an informal inquiry. To the best of my knowledge, for example, Enron was a story in the press before it was a subject of SEC investigation, as were many of the other recent scandals.[37]

### C. THE POTENTIAL FOR HOME BIAS IN SEC ENFORCEMENT

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[36] See DONNA NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 624 (2003).

[37] For a criticism of the SEC's handling of Enron, see FINANCIAL OVERSIGHT OF ENRON: THE SEC AND THE PRIVATE SECTOR WATCHDOGS – REPORT OF THE STAFF TO THE SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS, October 8, 2002.

Based on the foregoing, my prediction is that there would be a systemic bias in favor of SEC enforcement actions directed at subjects with a strong presence in the U.S., as opposed to subjects who operate extraterritorially. Some evidence along those lines already exists: a study by Siegel found only a very small number of actions against foreign issuers over a multi-year period.[38] A close look at the costs and benefits associated with allocating scarce enforcement resources along a number of dimensions suggests that the difference is likely to persist.

1. *Costs*

The simplest point should be fairly clear: on average, investigating and pursuing a securities claim is likely to cost more when subjects are located in foreign countries. Travel costs will be higher, and the possibility that testimony and documents will be in a foreign language will make the investigation slower and more difficult. Even were the SEC to open branch offices in other countries (as it no doubt someday will), the additional costs will still be considerable. And, of course, to the extent that subpoena enforcement or litigation requires the involvement and cooperation of regulators from another country or the local judiciary, there will be another layer of expense.[39] Expense also has a temporal dimension: foreign investigations are likely to take longer, meaning that the opportunity costs associated with committing to a foreign case will be higher. Just from these points, we might predict that given two possible investigations of roughly

[38] JORDAN SIEGEL, CAN FOREIGN FIRMS BOND THEMSELVES EFFECTIVELY BY SUBMITTING TO U.S. LAW? (MIT Working Paper, Sept. 2001), discussed in Coffee, supra. Interesting, and amply consistent with my analysis, is the fact that more than 40% of the foreign firms in the Siegel sample were Canadian. See MICHAEL R. KING & DAN SEGAL, INTERNATIONAL CROSS-LISTING AND THE BONDING HYPOTHESIS 2 (working paper, March 1, 2004).

[39] And perhaps roadblocks, notwithstanding formal commitments toward cooperation. See Amir Licht, *Games Commissions Play: 2x2 Games of International Securities Regulation*, 24 Yale J. Int'l L. 61 (1999).

equal probability of benefit, the domestic matter would likely have the higher expected value.

2. *Discovering Evidence of Possible Wrongdoing*

In the literature on home bias among investors, one explanation is that in an environment of high information costs, investors will take note of stocks that generate salient news, which is more likely closer to home.[40] The same point, presumably, relates to regulators. Recall that SEC investigations are often prompted by news reports or other salient events. Commission staff members will observe more domestic news than foreign.

We should not overstate this, for there are some simple remedies to overcome an informational bias alone. Some enforcement staff could be detailed to look only for foreign matters worthy of investigation. However, for reasons discussed below, I doubt that the SEC would want to commit to anything that would counter a home bias completely.

3. *Benefits: The Diffusion of Interests in a Multinational Setting*

Another fairly basic point has particularly interesting implications in a globalized capital marketplace. Consider an issuer with 33% U.S.-based investors. Any benefit from a successful enforcement action goes mostly to non-U.S. investors, even thought the costs will be predominately borne by the SEC. On average, the choice between investment in foreign versus domestic investigations will favor the latter. We have emphasized, however, that investor interests are but part of the story. Perhaps the stock exchanges and the securities industry would pressure the SEC to bring a

[40] E.g., Huberman, supra.

larger number of foreign cases to assure the credibility of the U.S. "bond" and so generate more cross-listing and transactional business in the U.S. by foreign issuers.

One response to this is that the diffusion of organized interests in the U.S. is such that these alone would not be enough to offset the economics otherwise favoring a home bias. Moreover, the incentives of the exchanges and securities firms is somewhat muddled. The internationalization of the investment banking business makes it so that business is likely to be captured by a small number of multinational firms regardless of location. The exchanges and trading systems have a stronger incentive, because cross-listings do generate listing and transaction-based income. My suspicion, however, is that the technology-driven fragmentation of global trading is severely eroding the economic value associated with "listings." As we move toward a point where no single exchange will have a dominating position in the trading of any given stock, the incentives of the exchange begins to look much like that of the regulator. It will have more of an interest in those issuers for which it has the largest market share, less where there is more fragmentation. And if fragmentation comes to be the order of the day generally, then no trading site will have enough incentive to invest heavily in monitoring or enforcement, and the concept of listing as a bonding device will begin to disappear.

The more important point, however, is that stock exchanges have little need to pressure the SEC toward a system of proportionate enforcement in order to gain listing fees. As Jack Coffee has pointed out, even a discriminatory system favoring domestic enforcement can still support a healthy cross-listing environment[41] – the U.S. commitment to enforcement simply has to be better than what is offered elsewhere to make cross-listing worthwhile to issuers from countries with weak investor protection regimes. If what I said above is right that the long-run returns

[41] See Coffee, supra.

associated with competing for listings are diminishing, then just offering a little bit of enforcement internationally would be a politically stable strategy – strong potential competitors are unlikely to emerge (especially as long as European securities regulation remains fragmented).

My point so far has related solely to the exchanges and their incentives to enlist the SEC on their behalf. In theory, at least, the problems associated with trading fragmentation become less important when we shift our focus away from the exchanges to the SEC itself – why couldn't it rent out its enforcement capacity by creating a fee-funded international division, with fees set high enough to offset the higher costs associated with cross-border work? If the value of SEC enforcement is indeed great enough from a cost-of-capital perspective, enough issuers desiring greater international exposure would presumably choose to commit.

Were the SEC structured differently (and certain other conditions satisfied), there might be something to this. The existing structure, however, creates a different set of incentives, along the lines described earlier. Though it easily could be, the SEC is not a self-funded agency: all fees go to the U.S. Treasury, and the entire budget of the Commission comes via the appropriations process. This is a carefully chosen political solution, one that gives both Congress and the White House more control over the SEC than would otherwise be the case. With that choice made, the SEC's incentives are necessarily political rather than economic.

Furthermore, we return to a point just made about stock exchange incentives. The SEC need only offer a little more than other regulators to make the U.S. the cross-listing site of choice for foreign issuers in need of bonding assistance, and in a fragmented but integrated capital market, the likelihood that other regulators will invest heavily enough to compete with respect to issuers beyond their home region is small. Like Delaware in state corporation law, the U.S. may have a lead that is not worthwhile for other to

try to erode.[42] If so, then the U.S. is unlikely to incur the costs to implement a more comprehensive system of extraterritorial regulation.

4. *Political and Internal Incentives*

At first glance, it might seem that domestic politics would favor the opposite of a home bias. The subjects of extraterritorial enforcement presumably have less political clout than those domestically, so that focusing the SEC's attention abroad would lower the heat here. The answer to this again goes back to our earlier discussion about politics – there is little evidence of the kind of consensus among the organized interests to effectively cause such a result. Indeed, if there is anything to the notion that the SEC adds economic value by allowing good companies to more credibly distinguish themselves from the bad, then the good companies in the U.S. would likely insist on more careful policing domestically, against those with whom the good most clearly compete for capital. Good regulation begins at home, and in the face of scarce resources, may stay there. The securities industry and the exchanges also have good reason to insist on a strong domestic focus – the greatest threat to their reputation (and the portion of their economic rents derived from investor confidence) is the sense that the U.S. cannot even keep its own house in order.

A home bias is also consistent with the SEC's internal incentives. To some extent this overlaps points already made: domestic issues are more visible and easier to address than foreign ones, and more cases can be done domestically than internationally. Because the SEC is anxious to leverage by creating the impression of productivity, volume counts. There are also more subtle points. The internal culture of the agency feeds on salient

[42] E.g., Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stan. L. Rev. 679 (2002); Mark Roe, *Delaware's Competition*, 117 Harv. L. Rev. 588 (2003).

accomplishments, which are more likely (all other things being equal) when both the impact and the publicity are closer to home. The Commission staff will happily take on a Parmalat-type case – though probably not do enough to expose it in the first place – because it is on a world-wide stage. The less visible foreign issuers are the ones more likely to be ignored.

Finally, there is a disincentive that comes from the demands of cooperation. As is familiar in most all inter-agency turf battles, cooperation requires giving up control and credit, and bureaucracies do that poorly. Given a choice of an enforcement action over which the SEC can maintain control and one where it will, in addition to incurring significant costs, be forced to act diplomatically and perhaps even dim its own lights to induce continued cooperation, the former is more attractive. All other things being equal, that preference, too, ripens into a home bias.

5. *Evaluating the Consequences*

All of these points come together to suggest that the SEC's exercise of enforcement discretion – a central tool of policy formulation – will be biased in the direction of more attention to domestic matters. The Commission will continue to police extraterritorially but on a limited basis, with most of the emphasis on "world class" fraud. In some sense, this prediction is simply that SEC enforcement will mirror what we see on the regulatory side, where foreign actors explicitly face less regulation than their U.S. counterparts.[43]

By hypothesis, this will reduce the deterrence associated with regulation compared to that for domestic actors (which itself is probably

[43] Though that has changed somewhat after Sarbanes-Oxley. See Roberta Karmel, *The Securities Exchange Commission Goes Abroad to Regulate Corporate Governance*, 33 Stet. L. Rev. 849 (2004); Michael Perino, *American Corporate Reform Abroad: Sarbanes-Oxley and the Private Foreign Issuer*, 4 Eur. Bus. Org. L. Rev. 213 (2003). My prediction would be that the foreign application of these new provisions will be significantly under-enforced.

suboptimal) unless foreign actors misperceive and overestimate the threat because they are unfamiliar with the enforcement probabilities or something makes up for the deficiency. The former is a possibility, at least early on.[44] The SEC cultivates its role as a tough enforcer through publicity and other means, and lawyers and accountants – who gain from the work generated by a fear of liability – may well over-amplify the message. Over time, however, this misimpression is unlikely to persist. There is substantial evidence in the U.S. that fear of SEC liability rises and falls based on available feedback, such that there will be times when the threat appears extremely remote and noncompliance rates rise. It is hard to believe that foreign issuers will not gradually learn of the differential treatment and adjust their behavior accordingly.

As to the possibility of substitutes, let us assume for the moment that home country enforcement varies significantly and is often inefficient. One other possibility is that private securities litigation can make up the deficiency. U.S. courts have indicated a willingness to apply a fairly liberal extraterritorial scope to Rule 10b-5, though the record is somewhat uneven.[45] Other countries are at least giving serious thought to liberalizing their class action procedures in the investor protection area, so that the real fear will be of private rather than governmental action. There is at least anecdotal evidence that this is so in the U.S. My sense, however, is that many of the same biases that affect public enforcement will also affect private litigation, and that it will require a fairly substantial evolution in foreign civil procedure (and the legal profession in many countries) to create an efficient environment for the resolution of multinational frauds. Even in the U.S. – with its very active plaintiffs' bar – the incidence of class actions is limited to larger issuers who suffer big enough price drops to

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[44] See Coffee, supra.

[45] See generally JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS ch. 19 (4th ed. 2004).

create a credible inference of loss causation.[46] I suspect that given the cost effects, the segment of international issuers that will attract private litigants will be even narrower.

How troublesome this is depends on perspective. If world-wide financial markets efficiently price the risk of opportunism, then a double standard might actually have a virtue, along the lines that Merritt Fox and some others have claimed.[47] Fox argues that countries *should* have a home bias in securities regulation, because pricing efficiencies make investor concerns less pressing. The more important objective is to aid domestic issuers in the capital marketplace by reducing the risk of opportunism, which translates into more efficient allocation of productive inputs. The domestic economy gains to the extent that it does this job of separating lemons from the sweeter fruit.

If one has less faith in pricing efficiency, on the other hand, then the situation is more complicated. The risk is greatest with respect to issuers of ambiguous nationality – an increasingly large class as the world economy integrates. When neither the U.S. nor any other country has enough interest to take lead responsibility for monitoring and enforcement, then it is likely that these firms will fall through the cracks so that gaps in regulatory coverage appear.

## D. LESSONS FOR THE EU

### 1. *Home Bias*

[46] For some data on the selection bias fraud on the market litigation, see Stephen Choi & James Bohn, *Fraud in the New Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. Pa. L. Rev. 903 (1996).

[47] Merritt Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 Mich. L. Rev. 749 (1998); Merritt Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment*, 85 Va. L. Rev. 1335 (1999).

For Europe, the main lessons from this bring us back to both scale and accountability. First, there is no reason to assume that the U.S. is the world's de facto enforcer simply because of the way it has articulated its jurisdiction. Second, so far as the design of a European regulatory regime is concerned, standard setting and enforcement cannot be separated without a severe loss of regulatory quality: enforcement discretion is a key standard setting mechanism. And if enforcement discretion has a local bias, then a fragmented system of enforcement will create a series of gaps. As to the EU, if we assume that national regulators will exhibit similar biases, then the absence of a centralized enforcement authority will lead to a great deal of regulatory unevenness – even if there is a high degree of harmonization of the particular standards to be applied. Unless one believes that a newly created agency would over-enforce in a way that is worse than fragmented under-enforcement, the argument would seem to cut considerably in favor of a European SEC.

The same would be true if one accepts Merritt Fox's argument. To the extent that Europe is seriously interested in economic integration, then it becomes important to have a system in place that allocates productive resources efficiently, and does not let one country's firms gain an unfair advantage over others. Lax enforcement in some countries hinders efficient integration. And, of course, there is a risk of enforcement protectionism. Choices either not to pursue a domestic issuer or to deliberately pursue a foreign competitor raise a serious risk, especially in countries with a more concentrated financial services or industrial sector so that the possibility of regulatory capture is greater.

So it seems to me that the normative case for a European SEC is compelling if one assumes the objective of capital market integration, so long as there is a reasonable expectation of accountability from the centralized regulator. I am well aware that such an assumption is questionable, and that practical politics stand in the way of the sense of

vision expressed by the Treaty of Rome. Gerard Hertig and Reuben Lee even suggest that though a European SEC is likely to emerge, it will lack serious enforcement powers, at least initially, because those powers are too threatening to particular countries. Based on the analysis here, that would significantly compromise the regulatory apparatus.

### 2. *Transplanting the SEC*

Putting aside the specific question of likely home bias, our inquiry into the SEC's enforcement incentives also suggests some lessons with respect to the design of a European counterpart. It is not necessary that we pass judgment on whether the SEC on average delivers high quality regulation, something over which people quarrel.[48] A close look at the Commission points out many of the institutional features that make it what it is. Should it move in the direction of an EU securities regulator, Europe will have to decide how many of these institutional features should be incorporated, and think hard about what it will get if key features are altered. And because of inevitable cultural and political differences, there is a risk that some features may not be transplantable at all. My aim here is simply to review some of those institutional features, leaving to others the question of inter-continental compatibility.

*Politics*. The SEC's status as a mildly bipartisan, "independent" regulatory agency is significant. The presence of at least two commissioners from the outside political party creates points of entry and influence for the constituencies that might otherwise be disenfranchised at the time. There is far more transparency in the agency's operations as a result. In this setting, compromise is also more likely – no interest group

[48] A study by Howell Jackson and Eric Pan found a fairly high degree of respect for the SEC's regulation by lawyers and others involved in European capital raising transactions. Howell Jackson & Eric Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – Part I*, 56 Bus. Law. 653 (2001).

wants dissenters who will send alarms to their strongest constituents, or generate publicity that risks arousing the investing public. This is a substantial moderating influence.

Drilling down a bit deeper, that moderating influence is in turn the product of interest groups that offset each other. To repeat, retail investors are not influential except in rare political crises. But the fear that they could become aroused in the face of a substantial decline in stock market prices or broad scandals is serious,[49] and no interest group wants to be caught on the wrong side of investor anger. In that sense, broad public participation in the stock markets is very much part of the SEC's institutional landscape. So is the emergence of strong political voices on the investor side, largely associated with labor unions, pension plans and other large institutions. While these cannot dominate and may well have agendas different from the interests of retail investors, they do operate defensively and can bargain for certain policy shifts. Even the business community is far from monolithic – as noted earlier, the securities industry and the issuer community often conflict in their interests, and key members of each group recognize the importance of a solid baseline of regulation to protect against unfair competition by dishonest actors (or to protect against too-easy entry by start-ups). The securities industry, in particular, seems to recognize that investors must be encouraged to invest and feel safe in so doing, and wants the Commission to play an expressive role in creating the right impressions.

My sense is that the SEC would be a very different institution were it not for this diversity of special interests, with substantially less autonomy. Nor would it be anything like it is without the latent presence of broad public shareholdings. On the other hand, the political dynamic is an accountability device, preventing too much of a shift in any one direction. For example, this explains the SEC's willingness to deregulate substantially

[49] See Coates, supra.

in "institutional" markets even though it maintains fairly tight control over access to the public markets.

*Economics*. Another important institutional feature is that the SEC cannot directly internalize the costs and benefits that it generates; its budget is under Congressional (and executive branch) control. It must regularly bargain for resources – which are kept fairly scarce – thus making the agency more politically accountable.

Attention to resource needs explains much. The other political branches have only an indirect interest in the substance of regulation, and regularly permit interest groups to intervene. Again, this points in conflicting directions. Members of Congress may well threaten intrusive regulation (even over the Commission's objections) in order to induce political contributions or other forms of support. The SEC then often plays the role of broker, forming alliances and offering more moderate treatment – with large amounts of enforcement discretion built in – by way of alternative. The result can be an enhancement of its own resources plus closer cooperation with the interest groups. Europe would get a very different agency performance if resources were made less subject to these political pressures, or if the political power were more concentrated, as is the case with financial institutions in some countries.

*Culture*. The SEC has some autonomy because of the conflicting external interests just described, and has developed an internal culture in adaptation to the agency's political and economic environment. The culture – which promotes certain myths about the Commission's function and history – makes the agency more functional because it helps coordinate and motivate behavior that might otherwise devolve into simple bureaucratic slack.

It would be naïve to think that this kind of culture would spring up easily. The SEC's roots were planted in the crisis of the 1930's, with a resulting ideology reflecting the politics of the times. The curiosity is how

it transformed once that first generation was gone. Because they play a crucial coordinating role, cultures are "sticky" – constant change is disorienting rather than stabilizing. But they become routine and less potent unless cultivated. At some times in the Commission's history, strong motivation was provided by a continuing identity of opposition to elite political and economic interests. Some of this was a legacy of talented senior officials whose ethnicity was not as welcome in corporations and law firms as it is today. (Put bluntly, a strong Jewish subculture was a crucial part of SEC history, especially from the period after World War II through the early 1970's[50]). But precisely because of welcome social change, that oppositional culture diminished, too, although it is not gone entirely.

The question today is what, if anything, still feeds the culture. To some extent, suggested earlier, the cultivation is deliberate: the campaign against insider trading was a way of generating symbolically rich victories for both internal and external audiences. Another possibility, albeit risky, is to harness the fact of staff turnover by creating an internal tournament that rewards short-term loyalty to the Commission's mission by conferring credentials that are readily marketable once the person decides to leave. Once again, aggressiveness and willingness to regulate are adaptive behaviors for lawyers in particular, even if they ultimately expect to be on the other side.

My suspicion is that none of this would be sustainable, however, absent the political conditions noted earlier. A functional SEC is in the interest of many groups, who have to be willing to tolerate the cultural conditions necessary to its productivity. An important mediating role here is played by the legal profession, which has a particularly strong self-

[50] Louis Loss tells of having little choice but to seek a government job in the 1930's because of this – leading to one of the most important careers in the history of securities regulation. LOUIS LOSS, ANECDOTES OF A SECURITIES LAWYER 28-29 (1995). The legacy of discrimination within legal institutions is a story hardly unique to the SEC, of course. See, e.g., LINCOLN CAPLAN, SKADDEN: POWER, MONEY AND THE RISE OF A LEGAL EMPIRE (1993).

interest in SEC productivity – and indeed benefits from SEC aggressiveness. SEC alumni play key roles in working out compromises among interest groups and the Commission, and are the prime facilitators of the transfer of human capital back and forth between the SEC and the private sector. That, too, is an institutional feature without which we would observe very different kinds of behaviors.

Because culture is so multi-factored and path dependent, this is a particularly hard matter to think through in terms of European transplantability. Suffice it to say, however, that institutional design must seek to produce accountability notwithstanding some bureaucratic autonomy from political forces. If culture does not do this, something else must.

*The Role of the States*. One important institutional feature is something we have not yet addressed. In 1934, Congress created the SEC without taking power away from the states. They continued to have a role with respect to both mandatory disclosure in capital raising transaction (the traditional focus of "blue sky law") and antifraud enforcement. Over time, that role has diminished. But as New York Attorney General Elliot Spitzer and others have shown recently, it remains potent, and if the states continue to see economic opportunity in securities enforcement, may grow. The political rise of the states' influence in investor protection because of the massive size of their public pension funds is one of the most important stories in the evolution of contemporary securities regulation.

There is an element of accountability here that should not be lost on a European audience.[51] The substantially blurred border between federal and state jurisdiction in securities regulation means that – if the political conditions are right – the states can challenge and compensate for SEC deficiencies. More routinely, the presence of the states also responds to

[51] See Roberta Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 Brook. J. Int'l L. 495 (2003).

what might be a spillover of home bias. For many of the same reasons, the SEC also exhibits a size bias: except with respect to symbolic areas like insider trading, SEC enforcement cases tend to focus on sizable misconduct appropriate to the Commission's national scale. Many state officials express frustration at the SEC's unwillingness to devote resources to smaller-level investment scams, even though the aggregate harm from their persistence is often considerable. Through their own organization (NAASA) state securities regulators have banded together in the last two decades to fill gaps left by the Commission, and it is this pattern of cooperation that has strengthened the willingness to challenge the SEC more aggressively.

*Private litigation*. One of the surprising features of SEC enforcement is how infrequent it is given the scale of the regulatory task. Constrained resources are an important institutional feature of American securities regulation. Indeed, especially before Sarbanes-Oxley, it is hard to see how there was much of any sense of deterrence from infrequent actions that were typically settled on terms the defendants were willing to live with. In this light, the role played by private actions is important; the number of such actions is greater than the number of public enforcement actions, and the potential exposure greater (putting aside criminal penalties).

As is well known in the U.S., a robust system of private securities litigation is a mixed blessing: some, perhaps substantial, level of speculative litigation results, which costs investors and others a considerable amount while benefiting lawyers on both sides considerably. The right balance of incentives is hard to achieve. However, there is a distinct possibility that without the supplement of easily-invoked private actions, public securities enforcement in the U.S. would require much greater resources to be anything near effective. For Europe, that would mean a choice between adopting the complex set of institutions required for private litigation or substantially more resources for the regulatory agency.

## E. CONCLUSION

Whether Europe should adopt an SEC is a hard question, even apart from the politics. As a matter of scale, it surely should. Indeed, if my point about home bias is generalizable, then even a pan-European scale is too small – and so is the U.S. scale. We should be talking about the need for a world-wide securities regulator, or at least contemplating the costs and gaps associated with not having one.

The issue is accountability, recognizing the ability of bureaucracies to stifle innovation. Unlike some, I do not presume that public agencies governing the capital markets necessarily do more harm than good to economic efficiency unless strongly prodded by powerful incentives. Like all institutions, bureaucracies are complicated and they can, under the right circumstances, be productive compared to other options. Looking at the U.S. SEC, one is struck by the complexity of influences that make it what it is. Whether one admires the SEC or not, we should admit that its replication in Europe would not be particularly easy. For better or worse, a European SEC would be a markedly different creature.

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