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Jonathan R. Macey

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POSITIVE POLITICAL THEORY AND FEDERAL
USURPATION OF THE REGULATION OF
CORPORATE GOVERNANCE: THE COMING
PREEMPTION OF THE MARTIN ACT

*Jonathan R. Macey**

INTRODUCTION

This Article is about the Securities and Exchange Commission (SEC) as a political entity. The basic story is that the SEC, like other administrative agencies, is a creature of the political system, and, as such, responds in varying ways to political pressure. From this starting point, I observe that the SEC is no exception among regulatory agencies in having a keen interest in maximizing its own power and prestige. As such, the SEC is responsive to political pressures.

While the term “bureaucracy” is often associated with notions of inefficiency, “[i]n the economics literature, the term ‘bureaucracy’ is associated with *ex ante* optimal constraints” on agents such as employees and political actors.¹ Following the economics paradigm, I model the SEC as an administrative agency that maximizes its own agenda subject to constraints from the political process. The SEC wants to maximize, among other things, the size of its budget and the scope of its jurisdictional power. In order to do so, it must cater to the whims of the congressional agencies that are responsible for its budget. For example, in the fall of 2000, the SEC, under then Chairman Arthur Levitt, tried to address the issue of accounting firms’ conflicts of interest, particularly in the simultaneous delivery of accounting services and audit services to the same client. In response, Representative Billy Tauzin (R-La.), the Chairman of the House Committee on Energy and Commerce, “actively went to bat for Andersen” to deter the Commission in its support for legislation that would have restricted audi-

* Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law, Yale Law School.

1 Walter Novaes & Luigi Zingales, *Bureaucracy as a Mechanism to Generate Information*, 35 RAND J. ECON. 245, 257 (2004).

tors from selling consulting services to their clients.² When Levitt expressed his view that a conflict-of-interest potential existed for any accountant or accounting firm that provided both consulting and auditing to the same company, Tauszin sent him a four-page letter that was subsequently described as a “not very veiled threat” to attack Levitt’s own credibility.³ In that year, Tauszin received \$10,000 in contributions from Andersen, and he received a total of \$57,000 from Andersen before the firm’s indictment and collapse in 2002.⁴

The SEC is under acute political pressure, and has been for several years. The political pressure stems from two sources. First, the wave of major corporate scandals and collapses involving SEC-regulated public companies (e.g., Adelphia, Enron, WorldCom, Tyco, Global Crossing) and financial intermediaries and banks (e.g., Salomon Smith Barney, Credit Suisse First Boston, Janus, FMC, Strong) has caused people to wonder what the SEC has been doing, and why so much has gone wrong on its particular patch of regulatory turf.

Second, New York Attorney General Eliot Spitzer has launched what I have described elsewhere as a “hostile takeover” of the SEC.⁵ The New York AG (which, in this context, stands for both “Attorney General” and “Aspiring Governor”) has made a name for himself not only by vigorously pursuing corporate wrongdoing that the SEC appears to have been slow in pursuing, but also by loudly claiming to be doing the job that the Commission was supposed to be doing, only better, and with fewer people. It is in this way that Mr. Spitzer is staking his claim to being qualified for higher office.

This Article begins with a description of the political theory on which it is based. In the following section are some illustrations of how outside political pressure has affected the SEC. The final section contains my prediction for the new regulatory equilibrium that we will observe after Mr. Spitzer’s departure from the domain of hands-on securities regulation.

I. POSITIVE POLITICAL THEORY

Positive Political Theory (PPT) models of agency policymaking have explained, among other things, the tools that politicians can use

2 Gary Boulard, *Follow the Money*, THE TIMES OF ACADIANA (Lafayette, La.), Aug. 28, 2002, at 12, available at <http://timesofacadiana.com/html/877EE1A8-0B41-4B5E-8503-3D35BE7C559B.shtml>.

3 *Id.*

4 *Id.*

5 Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117, 128–33 (2005).

to control or influence agency decisions.⁶ These models differ sharply from earlier models in political science that depicted the delegation of decisionmaking authority to agencies by politicians as reflecting a cessation of power by the political branches of government.⁷ PPT has shown that politicians use the tools of *ex post* and *ex ante* control to overcome some of the agency problems associated with delegation (such as the inability to foresee the issues the agency will face). One way in which politicians can monitor and control administrative agencies is by structuring them in such a way that “capture” by certain interest groups is likely. The committee system represents another mechanism that Congress uses to control administrative agencies. Members of Congress are responsive to politically powerful interests within their districts. Empirical studies have shown that representatives of particular interests gain representation on certain congressional committees. Committees are composed of members who are significantly above-average supporters of particular interests.⁸ And these committees, in turn, exert varying degrees of control over the agencies that report to them. This leads to agency responsiveness to political considerations.

The SEC, for example, rarely deals with national banks when compared with the Comptroller of the Currency, whose only constituency is national banks. Thus, the Comptroller is far more likely to be captured by national banks, but the SEC is not likely to be so captured. By contrast, the SEC deals with investment bankers and their lawyers on a regular basis. Members of the securities bar constitute the SEC. The SEC reflects the interests of these constituencies.

While PPT models of political control do a good job of illustrating how and why politicians try to influence agency policymaking, it is possible to overstate politicians’ ability to do so. After all, there is considerable distance between members of Congress, and even congressional committees, and the work that goes on in agencies day-to-day. This gives administrative agencies some freedom in which to operate, subject to the concerns that their congressional oversight committee will respond negatively if they do anything that offends the committee’s interests. Negative responses range from reducing funding to

6 McNollgast, *The Political Origins of the Administrative Procedure Act*, 15 J.L. ECON. & ORG. 180, 182 (1999).

7 David B. Spence, *Administrative Law and Agency Policy-Making: Rethinking the Positive Theory of Political Control*, 14 YALE J. ON REG. 407, 407 (1997).

8 Barry R. Weingast & William J. Marshall, *The Industrial Organization of Congress; or, Why Legislatures, Like Firms, Are Not Organized as Markets*, 96 J. POL. ECON. 132, 151 (1988).

insisting on personnel changes or organizational changes that reduce the power and prestige of the agency.

Using a model first developed by Brian Marks,⁹ the basic idea, represented in Figure 1, is that at an original point in time, the administrative agency or court (in this case, the SEC) has been delegated the authority to make decisions. There is an extant status quo, and the enacting legislature, of course, has preferences about how they want the regulation or law to be interpreted and applied. Within the legislature, the House and the Senate, along with the relevant congressional oversight committees, also have preferences, but these preferences are heterogeneous.

The administrative agency has room to maneuver in this model. The agency can pick a response that will not trigger a congressional response, as long as the response is within a certain range of outcomes, because congressional intervention is costly. Since the two houses of Congress must agree to overturn a particular statute, bicameralism provides agencies and courts with "a range of choices they can make without fear of legislative reaction."¹⁰

Moreover, the congressional committee system delegates the authority to oversee a specific, substantive policy area to a particular, specialized subset of its members. Among the more well-established principles of PPT is that committees serve the role of insulating the effects of shifting legislative majorities by providing continuity, since committee members are more likely to share the interests of the original enacting Congress. Even if the original Congress changes composition, and hence point of view over time, it will be unable to affect policy change unless the relevant committee changes its views, because the committee will control the critical question of whether, and in what form, new legislation in a particular substantive policy area is introduced onto the floor of the House as legislation.¹¹

This, in turn, provides the agency with additional room to maneuver, because in order for the agency's interpretation to be over-

9 Brian Marks, *A Model of Judicial Influence on Congressional Policymaking: Grove City College v. Bell* (1989) (unpublished Ph.D. dissertation, Washington University, St. Louis) (on file with the Hoover Institute, Stanford University).

10 John A. Ferejohn & Barry R. Weingast, *A Positive Theory of Statutory Interpretation*, 12 INT'L REV. L. & ECON. 263, 267 (1992).

11 See McNollgast, *Legislative Intent: The Use of Positive Political Theory in Statutory Interpretation*, LAW & CONTEMP. PROBS., Winter 1994, at 3, 18 (explaining that "[i]n each chamber of Congress, at least one subcommittee and one full committee have gatekeeping rights in that a bill normally will not be considered by the entire legislative body until it has been approved in committee"). For a general overview of Positive Political Theory, see generally WILLIAM H. RIKER & PETER C. ORDESHOOK, AN INTRODUCTION TO POSITIVE POLITICAL THEORY (1973).

turned by Congress, it must not only upset the relevant congressional committee sufficiently to provoke new legislation, it must also lie outside the range of acceptable behavior to obtain passage in the House and Senate, either with or without a presidential veto.

On the other hand, if the agency were to pick some response outside of the interval of disagreement between the Congress and the relevant committee, the decision would be overturned by new legislation, because both the House and the Senate would prefer new legislation to the policies being pursued by the agency. Thus the distance between H #1 and C #1 and between H #2 and C #2 in Figure 1 shows the set of politically viable options at particular points in time, where "H" represents the perspective of the median legislative voter (House and Senate), and "C" represents the perspective of the relevant oversight committees. The wider the divergence between the SEC and the various "veto points" in the legislative process, the more freedom the SEC will have.

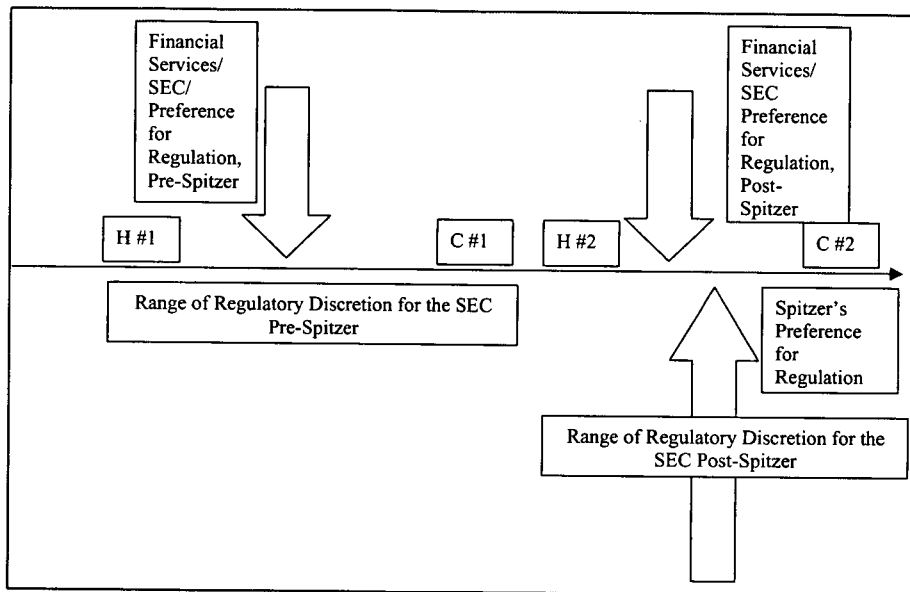
Because the SEC must appeal to Congress and to its oversight committees in a variety of ways, when Congress's point of view shifts, the SEC's point of view must shift as well, or else it will provoke new legislation. This is true regardless of the content of the original enacting legislation that the SEC is interpreting, and regardless of the personal preferences of the SEC or the staff. Failure to respond to the new equilibrium simply will provoke new legislation.

Of course, one of the things that the agency will take into account when determining what course of action to take is its concern for its own relationship with Congress, particularly in light of Congress's control over the agency's budget. Hence, following Ferejohn and Weingast, I model the relevant government agent (here the SEC) as being largely unshackled from textual constraints¹² and free to interpret the statutes they are applying quite liberally. However, budgetary concerns are not the agency's only priority, particularly since Congress can affect only the budget of the agency, and not the salary of individuals within the agency. Nevertheless, agencies are not indifferent to

12 *Chevron U.S.A., Inc. v. Natural Resource Defense Council, Inc.*, 467 U.S. 837 (1984), signaled the appellate courts to give more discretion to administrative agencies in statutory interpretation. However, where there is a significant variance between the courts' views and those of the administrative agency, the agency will have to modify its views to account for the possibility of judicial nullification. See Linda R. Cohen & Matthew L. Spitzer, *Solving the Chevron Puzzle*, LAW & CONTEMP. PROBS., Spring 1994, at 65, 65; William N. Eskridge, Jr. & John Ferejohn, *Making the Deal Stick: Enforcing the Original Constitutional Structure of Lawmaking in the Modern Regulatory State*, 8 J.L. ECON. & ORG. 165, 165 (1992). Of course, the courts must be worried about the legislature re-instating the administrative agency's point of view.

the preferences of Congress, particularly to the preferences of the relevant congressional oversight committee, because they care about their budget, and they care about possible congressional incursions into their jurisdictional turf, which will happen where Congress narrows the grant of administrative authority to an agency or grants administrative authority to a rival agency, such as the Commodity Futures Trading Commission.

FIGURE 1. POLITICALLY VIABLE POLICY INTERPRETATIONS FOR THE SEC AT TIME 1 AND TIME 2



II. ENRON, ELIOT SPITZER, AND THE MARTIN ACT: EXOGENOUS SHOCKS TO THE SEC'S PEACEFUL DOMINANCE OF THE CAPITAL MARKETS

As is the case in markets generally, the level of regulation (quantity of output) that we observe at any particular point in time represents a particular equilibrium among competing interests. And, like other markets, political markets are subject to exogenous shocks, and also to the revolutionary effects of entrepreneurial activity by ambitious politician-bureaucrats. The SEC has been buffeted by both in abundance.

The meltdown of major public corporations subject to the SEC's annual and periodic reporting requirements represents an exogenous shock. The entrance onto the national political scene of a provincial regulator, New York's Attorney General, reflects the height of political

entrepreneurship.¹³ The recent scandals concerning market timing and late trading in the mutual fund industry, the spinning and laddering issues in the market for Initial Public Offerings, and revelations concerning conflicts of interest facing sell-side stock market analysts reflect a combination of exogenous shock and political entrepreneurship. These are all areas in which Mr. Spitzer initiated enforcement actions and other sorts of litigation in order to regulate U.S. capital markets, the SEC's core policy area. Acting as a classic political entrepreneur, Mr. Spitzer caused the exogenous shock by exposing these issues and making them politically salient, much to the embarrassment and discomfort of the SEC.

The disequilibrium created a window of opportunity for the formulation of new regulation. Within two weeks after Mr. Spitzer reached a settlement with Merrill Lynch regarding analyst conflicts of interest, Representative Michael Oxley (R-Ohio), Chairman of the House Committee on Financial Services, wrote a letter to the *New York Times* observing that

[w]hat we are witnessing is nothing less than a regulatory coup that would usurp the proper role of the S.E.C. [sic] and the self-regulatory organizations. This could result in a disastrous balkanization of oversight, meaning that every Wall Street firm would have to cut its private deal with every state attorney general or face the potential threat of fraud charges.

In this time of lagging investor confidence, policymaking through litigation discussed in a closed conference room is not healthy for the U.S. capital markets, and not good for investors.¹⁴

In 2003, the issue of federal preemption of Mr. Spitzer's activities emerged in the form of H.R. 2179, the proposed Securities Fraud Deterrence and Investor Restitution Act of 2003.¹⁵ The bill contained additional enforcement powers for the SEC, but included provisions flatly banning states from making any laws or reaching any settlement the requirements of which "differ from or are in addition to the requirements in those areas established by the [SEC] by a national securities exchange or self-regulatory organization [SRO]."¹⁶ The

13 For another perspective on how the Attorney General views his role as securities regulator, see his website, <http://www.oag.state.ny.us/investors/investors.html>.

14 Michael G. Oxley, Letter to the Editor, *Who Should Police the Financial Markets?*, N.Y. TIMES, June 9, 2002, at BU11.

15 Securities Fraud Deterrence and Investor Restitution Act of 2003, H.R. 2179, 108th Cong.

16 Tim Reason, *Cheese It, the States!*, CFO, Feb. 2004, at 53, 56 (explaining and quoting H.R. 2179), available at http://www.cfo.com/article.cfm/3011459/c_3046605?f=magazine.featured.

provision was later dropped from the proposed bill.¹⁷

While actual preemption has not yet become a reality, I predict that it will. Mr. Spitzer himself has no reason to oppose it—after he has left office—and it is unlikely that Mr. Spitzer's successor will be powerful enough to stave off a major legislative effort. In congressional testimony in June 2002 on the subject of analysts' conflicts of interest, Mr. Spitzer said he agreed with the need for national standards and has always opposed what he called

“increased federalism—a belief that the federal government should scale back its involvement in our nation's affairs.” However, he added, “Congress and the federal government cannot have it both ways. If Congress and the executive branch decide to curtail federal oversight of areas such as securities, they must recognize it is the responsibility of state securities regulators like me to step in to protect the investing public.”¹⁸

In this context it is important to observe that Mr. Spitzer did not mount his initiative to regulate the securities markets (and along the way to politically embarrass the SEC and the administration) until his political party had lost control of the White House to the Republicans.

Increased federal regulation already has come in the form of the Sarbanes-Oxley Act¹⁹ and the new corporate governance rules recently adopted by both the New York Stock Exchange²⁰ and Nasdaq Stock Market.²¹

One obvious question is why the SEC permitted such a regulatory vacuum to develop. The SEC failed to pursue vigorously the various problems in financial reporting by public companies, conflicts of interest in investment banking, and agency problems in mutual funds. This passivity on the part of the SEC was likely caused by the agency's capture by the very special interests it was ostensibly regulating.²² However, it is also important to realize that this capture was only possible with the acquiescence of Congress and the relevant oversight committees that monitor the SEC and control its budget.

17 Phyllis Diamond, *Controversial Preemption Provision Dropped from SEC Enforcement Bill*, 36 Sec. Reg. & L. Rep. (BNA) 384 (Mar. 1, 2004).

18 Reason, *supra* note 16, at 56 (quoting Mr. Spitzer's testimony).

19 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

20 See Self-Regulatory Organizations, Relating to Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154 (Nov. 12, 2003).

21 See *id.*

22 See Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 922 (1994); John C. Coffee, Jr., *A Course of Inaction*, LEGAL AFF., Mar.-Apr. 2004, at 46, 49 (discussing the SEC's passivity with regard to the mutual fund crisis).

In other words, public policy crises, whether real or imagined, provide an opportunity for entrepreneurial politicians and regulators to break the typical logjams that make it difficult to pass new rules during times of ordinary politics. In earlier work, I have argued that Mr. Spitzer's response to this crisis was a natural and inevitable response to the vacant policy space created by the SEC.²³ New York's powerful Martin Act²⁴ was the lever with which Mr. Spitzer successfully catapulted himself from a relatively obscure local political position to national prominence.

Other states also have been entering this political market. In 2003, California enacted a new criminal securities statute,²⁵ and on the day it went into effect, the California Attorney General announced that he had launched an investigation of fees charged by mutual funds doing business in the state.²⁶ A number of other states, including

23 Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations in U.S. Regulation of Corporations and Markets Post-Eliot Spitzer*, Paper Prepared for the September, 2004 Conference on Changes of Governance in Europe, Japan, and the U.S.: Corporations, State, Markets and Intermediaries, Max-Planck-Institut für ausländisches und internationales Privatrecht & Japanisch-Deutsches Zentrum Berlin (JDZB) (Sept. 2004) (manuscript on file with author).

24 Martin Act, N.Y. GEN. BUS. LAW art. 23-A (McKinney 1996). The Martin Act "provides the regulatory framework governing the offer and sale of securities, commodities and other investment vehicles in and from New York." Orestes J. Mihaly & David J. Kaufman, *Securities, Commodities, and Other Investments, Supplementary Practice Commentary*, in N.Y. GEN. BUS. LAW art. 23-A, at 10 (McKinney 1996); see *People v. Landes*, 645 N.E.2d 716, 717 (N.Y. 1994); *CPC Int'l v. McKesson Corp.*, 514 N.E.2d 116, 119 (N.Y. 1987). Remedial in nature, it was enacted "to prevent all kinds of fraud in connection with the sale of securities and commodities and to defeat all unsubstantial and visionary schemes in relation thereto whereby the public is fraudulently exploited." *People v. Federated Radio Corp.*, 154 N.E. 655, 657 (N.Y. 1926); accord *People v. Lexington Sixty-First Assocs.*, 345 N.E.2d 307, 311 (N.Y. 1976); *Dunham v. Ottinger*, 154 N.E. 298, 300 (N.Y. 1926). The Martin Act "seek[s] to regulate parties selling securities and to advance the public's knowledge about the securities offered for sale." *Landes*, 645 N.E.2d at 718. The terms "fraud" and "fraudulent practices" under the Martin Act are

to be given a wide meaning so as to embrace all deceitful practices contrary to the plain rules of common honesty, including all acts, even though not originating in any actual evil design to perpetuate fraud or injury upon others, which do tend to deceive or mislead the purchasing public.

Lexington Sixty-First Assocs., 345 N.E.2d at 311; see *People v. Sala*, 695 N.Y.S.2d 169, 177 (N.Y. App. Div. 1999).

25 Act of Sept. 9, 2003, 2003 Cal. Stat. 876.

26 See Press Release, California Attorney General Bill Lockyer, Attorney General Lockyer Launches Investigation of Fraudulent Sales Practices by Mutual Funds (Jan. 2, 2004), available at www.ag.ca.gov/newsalerts/2004/04-001.htm.

Florida, Illinois, Massachusetts, and Pennsylvania, have initiated efforts to enact new state securities laws.²⁷

The Martin Act was passed in 1931. Its basic provision, as Professor Loss has observed, “has a majestic, one-sentence sweep.”²⁸ Whenever it appears to the Attorney General that, in connection with any security (or commodity) or investment advice, that any person has

[e]mployed . . . or is about to employ any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise, . . . or is about to employ, any deception, misrepresentation, concealment, suppression, fraud, false pretense or false promise, or shall have engaged in or engages in or is about to engage in any practice or transaction or course of business relating to the purchase, exchange, investment advice or sale of securities or commodities which is fraudulent or in violation of the law and which has operated or which would operate as a fraud upon the purchaser, . . . any one or all of which devices, schemes, artifices, . . . deceptions, . . . false . . . practices, . . . and courses of business are hereby declared to be and are hereinafter referred to as a fraudulent practice or fraudulent practices[,] or he believes . . . that an investigation [should] be made, he may in his discretion either require or permit such person . . . to file with him a statement in writing under oath or otherwise as to all the facts and circumstances concerning the subject matter which he believes it is to the public interest to investigate.²⁹

Whenever the Attorney General believes “from evidence satisfactory to him” that any person either is about to or has already engaged (or is engaging) in fraudulent practices, the Attorney General may sue to enjoin the practice, and may also sue to enjoin the defendant permanently from selling securities in the state, and for other relief that the Attorney General can convince the court is “proper.”³⁰ Refusal to testify is *prima facie* proof of having engaged in fraudulent practices for the purposes of obtaining a permanent injunction.³¹ And the Attorney General also has the power to request a court to appoint a receiver for “property derived [from] fraudulent practices,” including “commingled property.”³²

In *People v. Federated Radio Corp.*, the New York Court of Appeals clarified and perhaps even broadened the scope of the Martin Act,

27 Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 952 (2004).

28 LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 13 (1983).

29 *Id.* at 13–14 (quoting the Martin Act, N.Y. GEN. BUS. LAW art. 23-A, § 352).

30 *Id.* at 14.

31 *Id.*

32 *Id.*

holding that “fraud” is defined as “all deceitful practices common to the plain rules of common honesty.”³³ Going further, the court opined that the terms “fraud” and “fraudulent practice” are “given a wide meaning, so as to include all acts, although not originating in any actual evil design or contrivance to perpetuate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law.”³⁴ In other words, the term “fraud” in the Martin Act goes far beyond what the common law defined as fraud.³⁵

Using the Martin Act as a lever, Mr. Spitzer was able to leverage his relatively modest position in the world of securities regulation to threaten the primacy of the SEC as the nation’s primary regulator of capital markets. Mr. Spitzer exploited the opportunity made available by his ability to use the Martin Act, combined with the SEC’s quiescence. However, as might be predicted, the SEC responded to the challenge.

Consistent with insights of PPT, the aggressive prosecutorial actions taken by Mr. Spitzer created a new demand on the part of the SEC’s traditional constituency, the investment banking industry, for aggressive SEC action. The demand for aggressive action by the SEC was not a result of new regulatory fervor on the part of the SEC, but a desire on the part of industry for the SEC to displace the Attorney General and to regain its former position as the nation’s primary securities regulator.

Only when the SEC regains its position of primacy will industry be in a position to accomplish its ultimate goal: preemption of state regulatory power in the domain of securities regulation. This Article uses the power struggle between Mr. Spitzer and the SEC over corporate governance and regulation of the securities industry to demonstrate the point that the power to regulate,³⁶ as well as the power to refrain

33 154 N.E. 655, 657 (N.Y. 1926).

34 *Id.*

35 *See id.* at 658.

36 The notion of using regulation to benefit private parties rather than to serve the public interest was first developed formally by the University of Chicago’s George Stigler, who modeled the regulatory process as a function of the government’s ability to benefit private parties by restricting entry into markets, policing cartels, and legitimizing various price-fixing strategies. These devices, Stigler showed, make it possible for private firms to galvanize into effective political coalitions and to earn super competitive returns called economic rents. In a nutshell, Stigler showed how regulation can benefit the regulated, rather than the public. According to Stigler, the market for regulation consisted of providing value to politicians in the form of campaign contributions, efforts to organize voting, intimations of future jobs, and occasional outright bribes in return for favorable regulation. *See generally* George J. Stigler, *The*

from regulating,³⁷ and also to deregulate are sources of rents for governmental actors and provide rent-seeking opportunities for interest groups. Students of public policy and others interested in improving the quality of regulation and policy formation should understand the incentive structure under which policymakers and regulators operate.

The SEC's newfound regulatory fervor is the response to the new political environment in which the agency has found itself. This is not the first time that the SEC has been forced to respond to political pressure. In the wake of Enron's collapse, at least three House committees (Financial Services, Energy and Commerce, and Education and the Work Force), and no less than seven Senate committees (Governmental Affairs; Judiciary; Health, Education, Labor and Pensions; Banking, Housing, and Urban Affairs; Commerce, Science and Transportation; Energy and Natural Resources; and Finance) were investigating various aspects of the company's collapse, from the effect on investors and financial markets to the effect on natural gas markets. A central focus of the Senate Committee on Governmental Affairs was whether agencies of the federal government, including the SEC, could have done more to protect the enormous number of people and businesses that were hurt when Enron imploded.³⁸

In other words, as Enron and other corporate scandals became a more salient political issue, the political-support-maximizing solution

Theory of Economic Regulation, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). Major research advancing the "rent-seeking" (also known as the "public choice") approach to regulation has been contributed by James Buchanan, Sam Peltzman, Robert Tollison and Gordon Tullock. See generally JAMES BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962); James Buchanan, *Rent-Seeking and Profit-Seeking*, in *TOWARD A THEORY OF THE RENT-SEEKING SOCIETY 1* (James M. Buchanan et al. eds., 1980); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Robert D. Tollison, *Is the Theory of Rent-Seeking Here to Stay?*, in *DEMOCRACY AND PUBLIC CHOICE 143* (Charles K. Rowley ed., 1987); Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339 (1988); Gordon Tullock, *Rent-Seeking*, in *THE NEW PALGRAVE: THE WORLD OF ECONOMICS 604* (John Eatweh et al. eds., 1991). Consistent with one of the principal insights of this school of thought, this Article models politicians, bureaucrats and others involved in the policymaking process as rational economic actors who, subject to a variety of constraints, act in their own self-interest, rather than some vaguely defined conception of the private interest.

37 See generally FRED S. MCCHESENEY, *MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION* (1997) (describing rent extraction as payments from industries to politicians to avoid regulation).

38 In particular, Senator Joe Lieberman wanted to know whether cracks need to be filled in the regulatory system—including at the SEC. See Press Release, Senate Government Affairs Committee, Lieberman, Levin to Probe Enron Collapse (Jan. 2, 2002), available at <http://govt-aff.senate.gov/010201press.htm>.

for the SEC shifted from a benign, laissez-faire approach to market regulation to a more energized, hands-on regulatory approach.

A. *The Story of EDGAR*

All public companies, foreign and domestic, whose securities are issued or traded in the United States are now required to file registration statements, periodic reports, and other forms electronically through EDGAR, the SEC's electronic filing system.³⁹ Access to EDGAR is free.

While the SEC proudly touts the availability and usefulness of EDGAR, this was not always the case. As Carl Malamud reported on a first-hand basis in *Mappa.Mundi* magazine, the SEC had to be dragged kicking and screaming into the internet age:

In the summer of 1993, I was helping my friends at Sun Microsystems give a demonstration of the Internet to the Subcommittee on Telecommunications and Finance of the U.S. House of Representatives. It was a typical Internet demonstration: we hauled a couple hundred boxes of equipment into the U.S. Capitol, set it up overnight, and did a bunch of "the future is here" show-and-tell. Live video coming in from Russian satellites, cell phones hooked up to the net, yadda, yadda, yadda. Everybody was suitably impressed.

After the demonstration, [House Subcommittee on Telecommunications and Finance] Chairman Edward J. Markey, came up to me and wondered if I could look into something that was bugging him. His subcommittee had responsibility not only for the telecommunications industry, but also for oversight of the Securities and Exchange Commission. A bunch of Nader's Raiders had been sending in petitions to the subcommittee asking why the SEC filings weren't available on the Internet. The initial reaction from the SEC was that the reason the data wasn't [sic] on the Internet was that it was technically impossible, and that even if the data were available the only people interested in SEC filings were Wall Street Fatcats and they didn't really need subsidized access to data they were willing to pay for.

If something is technically impossible, I get interested. I looked at the EDGAR system and decided it was worth taking a crack at it. Our first cut at the problem was to try and work with the SEC. Chairman Markey's Chief of Staff asked the SEC to come in

39 EDGAR, the Electronic Data Gathering, Analysis, and Retrieval system, performs automated collection, validation, indexing, acceptance, and forwarding of submissions by companies who are required by law to file forms with the SEC. Sec. & Exch. Comm'n, *Important Information About EDGAR*, at <http://www.sec.gov/edgar/aboutedgar.htm> (last modified May 14, 2003).

and discuss the idea of giving us the data and letting us put together an Internet site. There was a bit of pushback, to say the least.

The problem was the 70's era data processing system that the SEC had put in place in the late 80's. The deal was that EDGAR was way too rough for consumers to digest. It needed, to speak the MIS lingo of the time, "value-add." Who would add value? Well, the SEC had cut a contract with a data wholesaler who would add value. The wholesaler, in turn, would sell to information retailers who would add even more value. Then, the information would be sold on the retail information market to the Wall Street crowd who had an interest in the data. Obviously, if we gave away all this information on the Internet, it would subvert our entire Free Enterprise System.

In that meeting with the SEC and the Chairman's staff, my favorite moment was when we got to the question of why in the world people would want to see EDGAR data. I maintained that the Internet was full of lots of people—students, journalists, senior citizen investors—who were dying for access to this data. The SEC felt that only a few people would want to see EDGAR documents, and besides the Internet (or "the ARPANET" as they kept referring to it) "didn't have the right kind of people."

Now, this was a cheap shot, and I understood that what they meant was "there weren't a lot of people, just a few researchers," but I couldn't resist.

"The right kind of people?" I said, rising up in my chair. "I think the *American* people *are* the right kind of people."

So much for the idea of working cooperatively.

After a bit of politics and some grantsmanship, I secured a small National Science Foundation grant, hit up my friends at Sun for a couple of computers, and in January 1994 launched a free EDGAR system on the Internet. The Retail Information Industry, which was making several hundred million dollars per year selling SEC filings, was not amused.

Brad Burdick of UUCOM (currently a full-time contractor working with Invisible Worlds) and I ran the EDGAR site for 18 months. We started with basic FTP access to data. Just to prove that our EDGAR site wasn't a cheap trick, we added the text of all U.S. Patents. Then, we moved towards searchable indices, a web-based front-end, and a variety of other components to make the site useful. We built up a user base of 50,000 people a day, and these people weren't just Wall Street Fatcats.

Our goal, however, wasn't to be in the database business. Our goal was to have the SEC serve their own data on the Internet. After we built up our user base, I decided it was time to force the issue. That's when the fireworks began. When users visited our EDGAR system in August 1995, they got an interesting message:

This Service Will Terminate in 60 Days

Click Here For More Information

Click here they did! One of the lessons I've learned from building Internet services is that when people get something for free, they want their money's worth.

Just by coincidence, the SEC had scheduled an EDGAR Technology Conference for August 14, 1995. We weren't invited, natch, but felt that it was a public meeting and it might be fun to attend. The purpose of the conference was to look at the question of filing EDGAR documents, not necessarily the question of disseminating EDGAR documents, but I suspected that our announcement on the Internet EDGAR service might skew the agenda.

I have to say that my faith in government was restored after this. The commissioners of the SEC had clearly not been aware of the issue, but there is nothing like pieces in the Wall Street Journal and 15,000 messages to the Chairman to raise the profile of an issue. We were called in to meet the commissioners and the Chief of Staff to explain what it would take to run an EDGAR service. The new head of MIS at the SEC, Mike Bartell, turned out to be a real live wire and he volunteered to have the SEC run the service.

After a bit of checking with the congressional oversight committees, the SEC said they were ready to go. We loaded a couple of computers in the back of a station wagon and drove down to SEC headquarters and set them up a system. On October 1, the day we had said we would terminate our service, the SEC was fully operational. Since then, they've embraced the EDGAR service on the Internet and made considerable enhancements. It has proven to be one of the largest U.S. government presences on the Internet and the staff is 100% behind their role in providing valuable public disclosure to the investing public. I even got a nice thank-you letter from the Chairman.⁴⁰

In other words, consistent with PPT, pressure from the relevant subcommittee caused the SEC to respond. This ultimately led it to abandon its allegiance to its traditional constituents, brokerage firms who wanted to erect barriers to the dissemination of information for as long as possible and the information wholesalers and re-packagers with which it had contractual relations, and to respond with a regulation in the public interest.

B. Regulation of the Mutual Fund Industry

Late trading and market timing were not only common practices, but the existence of such practices was well known to the SEC, which

⁴⁰ Carl Malamud, *The Importance of Being EDGAR*, MAPPA.MUNDI, Sept. 15, 1999, at <http://mappa.mundi.net/cartography/EDGAR/index.html>.

acquiesced in such practices until Mr. Spitzer came along to change the political climate. As Eric Zitzewitz has observed, the possibility that mutual funds could use pricing policies that permitted market timers and late traders to earn large trading profits at the expense of long-term shareholders was understood by the industry for twenty years and heavily exploited since the late 1990s.⁴¹

Because open-end mutual funds price their shares using the net asset value (NAV) calculated at the end of the business day (usually 4:00 p.m. Eastern time), investors can make riskless arbitrage profits by trading based on more recent market movements that are not reflected in the stale closing prices:

[I]f the U.S. market has risen since the close of overseas equity markets, investors can expect that overseas equity markets will open higher the following market. Investors can buy a fund with a stale-price NAV for less than its current value, and they can likewise sell a fund for more than its current value on a day that the U.S. market has fallen. Analogous opportunities exist when the values of infrequently or illiquidly traded domestic assets have recently changed.⁴²

Zitzewitz shows that arbitrageurs buying international funds on days the S&P 500 goes up and selling international funds on days the S&P goes down can generate returns of thirty-five percent to seventy percent a year, far better than the returns from investing in the funds themselves.⁴³ Smaller but statistically significant arbitrage returns are also possible by investing in other funds, including small-cap funds, convertible bond funds, high-yield bond funds, and similar funds that are thinly traded and illiquid.⁴⁴ Moreover, these abnormal returns earned by sophisticated investors can come at the expense of long-term fund shareholders.

Mutual funds companies could, if they were so inclined, impose internal trading rules that mitigated or eliminated the capacity of traders to engage in stale-price arbitrage by imposing transaction fees, monitoring excess trading, or adopting so-called "fair-value pricing" in which NAVs are calculated in real time, either continuously or frequently, using current market prices from the latest trades.

However, prior to the efforts of Mr. Spitzer, the SEC was reluctant to intervene on behalf of investors because "[t]he SEC normally avoids being overly proscriptive, preferring to allow the industry the

41 Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L. ECON. & ORG. 245, 245 (2003).

42 *Id.* at 246.

43 *Id.*

44 *See id.*

latitude to develop innovative ways of addressing [its] concerns. In this case, however, many fund companies appear to be abusing that latitude to essentially not respond to the SEC's concerns about shareholder dilution."⁴⁵

It has been reported that the late trading and market timing abuses in the mutual fund industry took place from June 2002 to September 2003, "when New York Attorney General Eliot Spitzer first sued companies involved in widespread fund trading abuses," according to the SEC itself.⁴⁶ The SEC, starting in late 2003, finally began to take an interest in abuses of mutual funds. It is hardly likely that the SEC's neglect of the problems in the mutual fund industry would have ended so suddenly without the pressure exerted by the New York Attorney General's interest in the issue.

C. *Analyst Conflicts of Interest*

Mr. Spitzer actually entered the world of securities regulation with his investigation of conflicts of interest. Starting with Citigroup and its star analyst Jack Grubman, Mr. Spitzer's investigation soon expanded to cover virtually every Wall Street brokerage company, including: Goldman Sachs Group; Credit Suisse First Boston (a unit of Credit Suisse Group); Morgan Stanley Dean Witter & Co.; the UBS Paine Webber division of UBS AG; the Salomon Smith Barney unit of Citigroup, Inc.; and Bear, Stearns, & Co.

As reported in *Financial Advisor* magazine, when asked why New York's Mr. Spitzer rather than the SEC uncovered this and other scandals, former SEC chair Arthur Levitt candidly observed that

[t]here were issues on which [the SEC] "couldn't seem to move," like the accounting and Wall Street analyst scandals. "I knew about this problem [conflicts of interest in Wall Street analysts' research] from running a brokerage," Levitt said. "And the accountants paid millions to seven lobbying firms to tie us up. We couldn't galvanize public, media and congressional support on this."⁴⁷

Levitt also was clear on the impact that Mr. Spitzer had on the regulatory process: "Once Enron, Arthur Andersen and WorldCom happened, Mr. Spitzer made creative use of the Martin Act in New

⁴⁵ *Id.* at 274.

⁴⁶ Siobhan Hughes, *SEC Sues JB Oxford, Clearing Arm*, WALL ST. J., Aug. 26, 2004, at D7.

⁴⁷ *Levitt Disavows Brokers' RIA Exemption*, FIN. ADVISOR, Mar. 2004, at 25, 25, available at http://www.financialadvisormagazine.com/articles/march_2004_frontline.html.

York state” to get involved in the regulatory process.⁴⁸ Thus, as with the more recent mutual fund crisis, the existence of analyst conflicts of interest was well known within the SEC. The SEC, however, did nothing to safeguard the interests of the investing public until Mr. Spitzer came along. This observation is not new. What is new is the point that the SEC was acting rationally: lacking the political support in Congress for a more active regulatory agenda, the SEC did not have the authority to police the capital markets more vigorously.

Evidence that the SEC has pursued what is, from its own interest, a rational strategy is apparent from looking at the growth in the SEC’s budget since the financial scandals began. The SEC enjoyed the largest budget increase of any U.S. administrative agency between 2002 and 2003, and the largest increase in memory for the agency.⁴⁹ Tellingly, these huge budget increases were strongly supported by the Investment Company Institute (ICI)⁵⁰ and the Securities Industry Association (SIA),⁵¹ the leading interest groups representing, respectively, mutual funds and the securities industry. Stunningly, the SEC’s budget more than doubled during the period 2001–2004, increasing from \$422,800,000 to \$913,000,000 during that period.

In 2001 SEC staff also garnered the largest pay increases of any agency, as Congress implemented the Pay Parity Act. The newly renamed House Financial Services Committee voted to increase the SEC’s pay at its first markup session, moving SEC employees to the same pay scale as employees of the Federal Reserve Board and the Comptroller of the Currency.⁵²

48 *Id.*

49 See Table 1 *infra* p. 969 and note 53.

50 Press Release, Investment Company Institute, ICI Supports Bush SEC Budget Proposal (Jan. 6, 2003), at http://www.ici.org/statements/nr/2003/03_news_sec_budget.html.

51 Press Release, Securities Industry Association, SIA Supports President’s Effort to Increase SEC’s Budget: Well-Funded Regulator Is Key to Building Public Trust and Confidence in Capital Markets (Feb. 4, 2003), at http://www.sia.com/press/2003_press_releases/html/pr_sec_budget.html.

52 Investor and Capital Markets Fee Relief (Pay Parity) Act, Pub. L. No. 107-123, 115 Stat. 2390 (2002) (codified at 15 U.S.C.A. § 78a (West Supp. 2004)); see also SEC. & EXCH. COMM., PAY PARITY IMPLEMENTATION PLAN AND REPORT (2002), available at <http://www.sec.gov/news/studies/payparity.htm> (describing the SEC’s approach to implementing the new compensation plan).

TABLE 1. SEC BUDGET HISTORY VS. ACTUAL EXPENSES BUDGET HISTORY—BUDGET AUTHORITY VS. ACTUAL OBLIGATIONS (\$ IN 000s)⁵³

Fiscal Year	Budget Authority	Actual Obligations	Percentage Increase from Previous Year
1990	166,633	165,211	—
1991	189,083	187,689	13%
1992	225,792	224,281	19%
1993	253,235	251,871	12%
1994	269,150	266,249	6%
1995	300,437	284,755	12%
1996	300,921	296,533	0%
1997	311,100	308,591	3.4%
1998	315,000	311,143	1.3%
1999	341,574	338,887	8%
2000	377,000	369,825	10%
2001	422,800	412,618	12%
2002	513,989	487,345	22%
2003	716,350	619,321	39%
2004	811,500	—	13%
2005	913,000	—	13%

Notes:

- (1) Actuals from Congressional Justification
- (2) Excludes SAM

D. Soft Dollar Commissions

Clearly the most interesting regulatory issue currently facing the U.S. capital markets are proposals to restrict what are known as “soft dollar commissions,” in which institutional investors, particularly mutual funds, pay for research and other services by directing stock trades at full commission to the firms providing such research. The many critics of soft dollar commissions say that the practice is not transparent, and it results in above-market commissions that reduce profits for

⁵³ Sec. & Exch. Comm’n, *Frequently Requested FOIA Document: SEC Budget History vs. Actual Expenses*, at <http://www.sec.gov/foia/docs/budgetact.htm> (last modified Apr. 4, 2003) (utilizing available data and calculating percentage increases).

fund investors.⁵⁴ Critics also claim that the practice of paying soft dollars for research permits mutual funds to breach their fiduciary duties to investors by enabling funds artificially to inflate profits by forcing investors to pay fees for research that fund managers are supposed to be doing with the money that investors already are paying in management fees and other fund expenses.⁵⁵ As some investors have posed the question: "If managers are already being paid an advisory fee, why should they be permitted to dip into client funds to pay for research they use in connection with managing client portfolios—even if the research may benefit clients?"⁵⁶

Supporters of soft dollar commissions argue that the mutual fund industry, led by the ICI, is engaged in a political campaign "to put America's best securities analysts out of business."⁵⁷ Supporters of the practice of paying soft dollar commissions point out that the analysts able to earn such commissions are top analysts on Wall Street, "not the lavishly compensated—and vastly overrated—superstars who work for the big Wall Street investment banks."⁵⁸ Rather, these analysts offer valuable information precisely because "their firms don't have any conflicted investment-banking relationships with the companies they cover. So these analysts don't have permanent Buy ratings on every stock."⁵⁹ In particular, defenders of soft dollar commissions assert that independent analysts, whose firms don't engage in underwriting, are more independent and hence more likely to be candid in their views of what companies to invest in.⁶⁰

Those opposed to regulating or eliminating soft dollar commissions, including groups like Buyside that represent institutional investors, cite numerous examples of how soft dollar commissions have produced great results for investors.⁶¹ Mark Roberts, of Off Wall Street Consulting Group, was the only analyst to have had a Sell rating on Enron as early as May 2001, well before the bottom fell out.⁶² Howard Schilit of the Center for Financial Research and Analysis

54 The Benchmark Cos., *2003: A Year of Awakening*, at <http://www.benchmark.alert.com/library/alerts/121603.html> (last modified Dec. 17, 2003).

55 *Id.*

56 *Id.*

57 Donald Luskin, *Sticking It to the Little Guys*, SMARTMONEY.COM, Dec. 19, 2003, at <http://www.smartmoney.com/aheadofthecurve/index.cfm?story=20031219>.

58 *Id.*

59 *Id.*

60 *Id.*

61 See Ben Mattlin, *Getting Tough on Soft Dollars: The SEC's Latest Target Could Have Sweeping Repercussions for Both Sides of the Street*, BUYSIDE, June 2004, at 58, 58–60, available at <http://www.buyside.com/archives/2004/0406/html/0406sdlr.asp>.

62 Luskin, *supra* note 57.

warned about Microstrategy in October 1999, before the stock fell by ninety-five percent in one of the first in the latest wave of corporate scandals, and, more recently, the accounting problems at Biovail before the stock fell nearly fifty percent. David Tice of *Behind the Numbers* pointed out problems at Tyco International in October 1999, Lucent Technologies in November 1999, and Providian Financial in July 2001, “all major train wrecks that Wall Street blithely ignored until it was too late.”⁶³ Scott Cleland of *Precursor* reportedly called WorldCom’s business a “dead model walking” in January 2002, and predicted the company’s bankruptcy.⁶⁴ In 2000, Cleland warned investors against Global Crossing, Qwest Communications and Level 3 Communications because his research exposed the myth of hypergrowth in Internet traffic, showing that actual growth was only about one-fifteenth as fast as these companies were claiming.⁶⁵

Soft dollar commissions emerged after the SEC was compelled finally to stop the legalized price-fixing of trading commissions. Price-fixing took the form of setting trading commissions at a fixed rate (\$0.75 per share at the time commission prices were deregulated in May 1975).⁶⁶ As with airlines, when prices were fixed, brokers competed for investor clients by offering additional goods and services. Commission deregulation led to much lower prices. Commissions are currently \$0.06 per share traded—a ninety-two percent decrease.⁶⁷

In response to complaints that brokerage commissions had sunk so low that brokers could no longer afford to pay analysts, analysts became more involved in marketing IPOs in order to justify their retention by investment banks. Soft dollar commissions were thought to be illegal because fund managers’ fiduciary duties to investors obligated them to find the lowest commission rates for their clients. In response to industry pressure, in 1975, as part of its National Market System legislation, Congress created a new “safe harbor” provision under section 28(e) of the Securities Exchange Act of 1934 that specifically allowed mutual fund investment advisors to pay higher commissions if the advisors thought that such higher commissions were in the interests of the fund.⁶⁸ In other words, “[m]oney managers prevailed upon Congress to insert legal protections specifically to allow soft dollar practices.”⁶⁹

63 *Id.*

64 *Id.*

65 *Id.*

66 Mattlin, *supra* note 61.

67 *Id.*

68 *Id.*

69 *Id.* (quoting Edwin Laursen, Baker & McKenzie, New York).

From a public choice perspective, the question is why the SEC has not regulated soft dollar brokerage as it has responded in the cases of EDGAR and mutual fund time-zone arbitrage, and late-trading. In my view, the SEC will respond, but it will do so only when it becomes clear that Mr. Spitzer will do nothing. In other words, absent Mr. Spitzer, the political-support-maximizing solution for the SEC would be to do nothing. We know this because Congress specifically empowered firms to pay such commissions in 1975 and has given no indication that it has changed its point of view.

The SEC will change when, and only when, it is forced to change, and it will follow Congress's lead when it finally does.

III. THE FUTURE

It is tempting to think the world will look tomorrow much the same as it looks today. The Martin Act, and hence the possibility of vigorous state regulation of the securities markets by the New York Attorney General, has been around for a long time. But that does not mean that it will be around forever. The SEC and Congress enjoyed a monopoly on power for several decades after the Securities Acts were passed in the 1930s. There is no reason to think that they would not prefer to revert to this condition as soon as possible.

The passage of Sarbanes-Oxley and the dramatic increases in the SEC's budget in the recent past, despite its dismal performance policing the nation's securities markets provides some evidence that Congress wants the SEC to retain its stature at the epicenter of the nation's capital markets. However, budget increases and Sarbanes-Oxley alone are not going to accomplish this goal. Preemption of the Martin Act will be required.

CONCLUSION

Whatever else we might think of regulatory agencies, they are political in nature. This is true of the Commerce Department, and it also is true of the Securities and Exchange Commission. A positive, i.e., descriptive, theory of the administrative process assumes that bureaucracies, including the SEC, are an important vehicle through which interest groups sustain and even extend the political victories they have won in Congress. This Article looks at the current regulatory crisis in the U.S. capital market from the allied perspectives of PPT and federalism in order to make two points about the current regulatory environment. First, I observe that the recent history of scandals, followed closely by new regulation, illustrates the importance of utilizing opportunities created by crisis. Crisis, in this case

manifested in the sudden collapse of Enron Corporation, followed closely by WorldCom and a spate of other highly salient corporate frauds (Adelphia, Global Crossing, Tyco), created the "policy window" through which political entrepreneurs could launch their initiatives. Moreover, the regulation that we observe at a particular juncture in time is not permanently in place. As political pressures change, as a result of exogenous events and technological change, so too will regulation.

The various governmental responses to the crises reflect the nature of the ongoing jurisdictional competition between and among state regulators and federal regulators in the U.S. federal system. State regulators, most notably New York's Attorney General Eliot Spitzer, moved decisively to fill what they viewed as a regulatory vacuum created by the SEC. The SEC and its congressional monitors have been forced to respond to this new competition. The long-run consequences of this competition, while far from clear, are likely to lead to a congressional counterattack in the form of preemption of New York's Martin Act. The capital markets will be weaker if this occurs.

