Rules, Principles, and the Competition to Enforce the Securities Laws

James J. Park*

Though the Securities and Exchange Commission (SEC) is the primary securities enforcer, multiple enforcers are active in enforcing the securities laws. Some scholars argue that enforcement should be centralized to eliminate or control enforcers with incentives to overenforce, while others contend that competition checks the SEC from a tendency to underenforce. The debate is characterized by a focus on whether the system produces an optimal quantity of enforcement.

This Article assesses the centralization debate through a different lens, emphasizing differences in the quality of enforcement, particularly the values that influence and are expressed by enforcement. To frame the discussion, it draws a distinction between two categories of enforcement: rule-enforcement and principle-enforcement. Rule-enforcement is less costly and controversial than principle-enforcement because specific rules tend to reflect the technical requirements of an administrative regime while general principles can reflect a wider range of values.

Enforcers differ in their approach in taking on the cost and controversy of principle-enforcement. Industry enforcers are likely to interpret principles narrowly based on industry values. Regulatory enforcers such as the SEC may find it difficult to adequately enforce principles because of the pressure of implementing consistent regulatory policy. Public-values enforcers such as federal prosecutors and state attorneys general are willing to enforce

* Associate Professor of Law, Brooklyn Law School. Thanks to Miriam Baer, James Fanto, Joan Heminway, Roberta Karmel, and Dana Brakman Reiser for helpful comments. Thanks to workshop participants at the Brooklyn Law School Junior Faculty Forum, Cardozo School of Law, New York City Area Junior Faculty Forum, Southeastern Association of Law Schools New Scholars Workshop, University of Iowa College of Law, and Vanderbilt University School of Law for helpful comments. Generous support was provided by the Brooklyn Law School's Dean's Summer Research Stipend Program.

principles in light of social values but may overreach because of political ambition. Entrepreneurial enforcers such as class action attorneys are most willing to invest in principle-enforcement but also have a tendency to bring questionable cases for profit.

The choice between a centralized and decentralized enforcement system is fundamentally a choice between a one-dimensional and multidimensional conception of the values relevant to securities enforcement. Proposals to centralize securities enforcement are motivated by a desire to eliminate the conflicts that can arise between enforcement approaches that reflect different values. The cost of such centralization is that the advantages diverse enforcers bring to the table will be eliminated. This Article concludes that a decentralized system is best justified by recognizing the particular strengths of different enforcers rather than focusing on whether an optimal amount of enforcement is produced.

Introduction 117
I. Centralizing Securities Enforcement 120
A. The Problem of Overenforcement 121
B. Proposals to Centralize Securities Enforcement 122
C. The Competition Argument for Decentralized Enforcement 127
D. The Problem with the Focus on Producing an Optimal Quantity of Enforcement 128
II. Rule-Enforcement and Principle-Enforcement 130
A. Distinguishing Rules and Principles 130
B. Rules and Principles in Securities Regulation 132
C. Distinguishing Rule-Enforcement and Principle-Enforcement 134
1. Cost of Enforcement 134
a. The Costs of Rule-Enforcement 135
b. The Costs of Principle-Enforcement 136
2. Controversy of Enforcement 137
a. The Meaning of Rule-Enforcement 137
b. The Meaning of Principle-Enforcement 139
D. Enforcement Strategy 142
III. The Tendencies of Securities Enforcers 143
A. Industry Enforcers: Self-Regulatory Organizations 143
B. A Regulatory Enforcer: The SEC 145
1. SEC as Bureaucracy 146
2. SEC as an Expert 148
3. Major Periods of SEC Enforcement 150
C. Public-Values Enforcers 154
1. Federal Prosecutors 154
2. State Attorneys General 157
D. Entrepreneurial Enforcers: Class Action Attorneys 159

IV. The Competing Values of Securities Enforcement 162
A. Enforcement Values 162
1. Industry Values 162
a. Predictability 162
b. Industry Standards 164
2. Regulatory Values 165
a. Consistency 165
b. Regulatory Policy 167
3. Public Values 168
a. The Burden of Anticipation 168
b. Societal Norms 169
B. An Uneasy Balance 170
V. Three Enforcement Models 172
A. Consolidated Enforcement 172
B. Supervised Enforcement 174
C. Decentralized Enforcement 176
VI. A Comparative Advantage System of Enforcement 178
Conclusion 181

INTRODUCTION

While the Securities and Exchange Commission (SEC) is undoubtedly the primary enforcer of the securities laws, it has often been overshadowed by other enforcers. State attorneys general and class action attorneys have been more active, innovative, and competent in enforcing the securities laws. Federal prosecutors have often seized an enforcement role through headline-grabbing convictions. Despite the fact that the SEC has the advantage of resources[1] and expertise, and brings hundreds of enforcement actions each year,[2] it is often criticized as passive and even incompetent.[3] By competing with the SEC and

1. The SEC enforcement division has a staff of over one thousand with more than four hundred investigative attorneys. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-358, GREATER ATTENTION NEEDED TO ENHANCE COMMUNICATION AND UTILIZATION OF RESOURCES IN THE DIVISION OF ENFORCEMENT 18 (2009) [hereinafter GAO REPORT].

2. For the past three years, the SEC has brought more than 650 enforcement cases per year: in 2010, it brought 681 enforcement cases; in 2009, 664 enforcement cases; and in 2008, 671 enforcement cases. *See* U.S. SEC. & EXCH. COMM'N, FY 2010 PERFORMANCE AND ACCOUNTABILITY REPORT 11 (2010), *available at* http://www.sec.gov/about/secpar/secpar2010.pdf; U.S. SEC. & EXCH. COMM'N, 2009 PERFORMANCE AND ACCOUNTABILITY REPORT 36 (2009), *available at* http://www.sec.gov/about/secpar/secpar2009.pdf; U.S. SEC. & EXCH. COMM'N, 2008 SEC PERFORMANCE AND ACCOUNTABILITY REPORT 12 (2008), *available at* http://www.sec.gov/about/secpar/secpar2008.pdf.

3. One wave of criticism occurred after the collapse of the internet bubble. *See, e.g.*, Mark Maremont & Deborah Solomon, *Missed Chances: Behind SEC's Failings: Caution, Tight Budget, '90s Exuberance*, WALL ST. J., Dec. 24, 2003, at A1. Another wave of criticism came after the recent financial crisis and Madoff scandal. *See, e.g.*, Joe Nocera, *S.E.C. Chased Small Fry While a Big Fish, Madoff, Swam Free*, N.Y. TIMES, June 27, 2009, at B1.

prompting it to act more aggressively, some legal scholars contend that multiple enforcers can help prevent underenforcement of the securities laws.[4]

On the other hand, there has also been a significant push to consolidate the number of securities enforcers and centralize more enforcement power in the SEC. Until the recent financial crisis, there were concerns that U.S. securities regulation had become too aggressive and unpredictable, partly because of its decentralized system of enforcement.[5] Competition between enforcers has been criticized as potentially leading to enforcement efforts that are popular but lacking restraint.[6] In addition, there is continuing criticism that private enforcers are likely to abuse the securities laws for selfish profit. For some legal scholars, the current system results in unproductive competition and conflict between multiple enforcers, leading to overenforcement.[7] These scholars propose that the SEC, as an expert administrative agency, should control enforcement activity so it reflects a uniform and consistent policy.

The tendency in the literature surrounding this debate, which relies heavily on economic theories of enforcement, has been to focus on whether the right amount of enforcement is produced, without drawing distinctions between types of enforcement cases. The limit of this approach is the absence of a meaningful way of determining what level of enforcement is optimal. Moreover, assuming that enforcement is essentially a uniform product implies that enforcers are fungible, producing the same output, and that a single enforcer could adequately generate that product on its own, tilting the debate in favor of centralization.

The effectiveness of enforcement must rest on more than the quantity of enforcement that is produced; quality matters as well. Routine enforcement matters have a different impact than enforcement cases that are on the cutting edge. While some enforcers may be satisfied with pursuing simple cases, other enforcers may be willing to take on challenging cases that involve greater cost and controversy. Fully understanding the merits of a decentralized system of enforcement requires understanding institutional considerations that shape

4. *See, e.g.*, *infra* Section I.C.

5. *See, e.g.*, U.S. CHAMBER OF COMMERCE, REPORT ON THE CURRENT ENFORCEMENT PROGRAM OF THE SECURITIES AND EXCHANGE COMMISSION 16 (2006) (noting concern "over multiple regulators or government authorities pursuing investigations or actions for the same conduct or transactions"). Commentators warned that without reform, issuers would shun the U.S. securities markets for foreign markets. *See, e.g.*, COMM. ON CAPITAL MKTS. REGULATION, INTERIM REPORT OF THE COMM. ON CAPITAL MARKETS REGULATION (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

6. Stephen M. Cutler, Director, Div. of Enforcement, Sec. & Exch. Comm'n, Speech at the F. Hodge O'Neal Corporate and Securities Law Symposium (Feb. 21, 2003), *available at* http://www.sec.gov/news/speech/spch022103smc.htm ("As public servants, we must admit to ourselves, however, the possibility that a contest to be the most *responsive* regulator could too easily become a contest to be the most *popular* but most *irresponsible* regulator.").

7. *See infra* Sections I.A–B.

enforcement activity. Different enforcers have different inclinations and abilities to bring different types of cases with different impacts.

This Article provides a richer understanding of the debate surrounding securities enforcement by offering a qualitative description of enforcement that takes into account the type of law that is being enforced. This Article divides securities enforcement into two categories: rule-enforcement and principle-enforcement. The distinction between ex ante rules, which are specific in what they require, and ex post principles, which are general in nature, is a fundamental way of categorizing law. In the context of securities regulation, rules tend to implement technical regulatory policy while principles reflect a wider array of values. The distinction between rules and principles is admittedly murky, and is best described as a continuum, but provides a framework that can be used to differentiate between two styles of enforcement.

Rule-enforcement and principle-enforcement differ in terms of cost and controversy of enforcement. First, rule-enforcement is generally less costly than principle-enforcement. Rules have clearly defined meanings and are meant to be easily applied to specific situations. Principles, on the other hand, are vaguely defined and require substantial investment in investigation and litigation to enforce. Second, rule-enforcement is less controversial than principle-enforcement. Rule-enforcement tends to target technical violations of a regulatory scheme and is less likely to result in moral condemnation and significant sanctions for the violator. In contrast, principle-enforcement involves application of broadly worded provisions with disputed meanings to firmly sanction conduct that violates public values.

Enforcers differ in their ability to take on the cost and controversy of principle-enforcement as well as the values that influence their enforcement of principles. Industry enforcers such as self-regulatory organizations (SROs) are more likely to focus on rule-enforcement and interpret principles narrowly in light of industry values, which value predictability and reliance on industry standards. A regulatory enforcer, such as the SEC, can find it difficult to aggressively enforce principles because its enforcement must be consistent with broader regulatory policy that reflects the work of an objective, expert regulator. Public-values enforcers, such as federal prosecutors and state attorneys general, are most likely to enforce principles aggressively in light of public values, but may be more likely to be influenced by politics than the SEC. Entrepreneurial enforcers, such as class action attorneys, have financial incentive to invest significantly in principle-enforcement, but also have incentives to bring questionable cases for profit.

Though the expertise of the SEC reflects one approach to enforcement, the SEC is not the only legitimate voice. Industry standards, regulatory policy, and public values all play some role in defining securities enforcement. Though such values may be in harmony at times, there is also potential for conflict. The choice between centralized and decentralized systems is not just about the

production of an optimal amount of enforcement but is fundamentally a choice between two different conceptions of securities enforcement—one monistic, the other pluralistic.

This Article assesses this choice in the context of three enforcement models—consolidated, supervisory, and decentralized. Each model reflects different degrees of centralization and different tolerances for pluralism. The consolidated model, which would reduce the number of enforcers, has the advantage of reducing conflict among enforcers, but also eliminates enforcers who can act more aggressively in expressing public values than an expert enforcer. The supervisory model seeks to retain the advantages of having multiple enforcers while controlling them through supervision, but it is unclear that supervision would add much to what the courts already do in screening meritless cases. The decentralized model has the advantage of relying on a wide array of enforcers with different approaches and strengths but can cause conflict and is costly.

This Article argues that the case for multiple enforcers is best made by emphasizing the comparative advantages of those enforcers, rather than focusing on whether an optimal amount of enforcement has been produced. Industry and regulatory enforcers are best at rule-enforcement, while public-values and entrepreneurial enforcers are best at principle-enforcement. Even if one enforcer could perform both enforcement roles, it might be more efficient for that enforcer to focus on what it does best. The SEC's expertise commits it to playing a particular role in the enforcement scheme that prevents it from effectively playing all roles. Reforms may be desirable in better defining the focus of different enforcers in order to reduce conflict between enforcers. Organizing securities enforcers in two tiers, one group focusing on rule-enforcement, the other group focusing on principle-enforcement, might be a way of managing the conflict that can result from multiple enforcers.

This Article proceeds in six parts. Part I summarizes the arguments for and against centralizing enforcement of the securities laws. Part II introduces the distinction between rule-enforcement and principle-enforcement. Part III describes differences among enforcers in their approach to principle-enforcement. Part IV discusses the different values that influence and are expressed by securities enforcement. Part V analyzes three models of enforcement that reflect different tolerances for pluralism in enforcement values. Part VI argues that an enforcement system that relies on multiple enforcers should stress the comparative advantage of different enforcers in pursuing certain types of cases.

I.
CENTRALIZING SECURITIES ENFORCEMENT

This Part describes the current debate over the structure of securities enforcement. Commentators have argued that consolidation or supervision of

enforcement is desirable because of the tendency of some enforcers to overenforce the securities laws. Advocates of decentralized enforcement have responded that competition among enforcers can prevent a captured regulator from underenforcing the securities laws.[8] The explanatory power of both approaches is limited by the focus on producing an optimal quantity of enforcement.

A. The Problem of Overenforcement

The criticism of decentralized securities enforcement is largely driven by the problem of overenforcement, the tendency of some enforcers to bring more cases than is socially optimal. Economic analysis of enforcement, which focuses on the incentives of enforcers,[9] observes that some enforcers may have an incentive to overenforce. Proponents of centralizing enforcement contend that enforcers with a tendency to overenforce should be eliminated or supervised by a public-minded enforcer that is more likely to exercise discretion not to enforce the law in certain circumstances.

Private enforcers have been singled out as having incentives to overenforce. As Steven Shavell has shown, a fundamental problem with relying upon private actors to enforce the law is that private actors do not internalize the social costs of enforcement.[10] For example, a private plaintiff does not bear the defendant's costs, which can take the form of legal fees and the hassle of defending a lawsuit,[11] and does not weigh these costs against the monetary benefits the plaintiff might capture by bringing a suit. As a result, private enforcers can have incentives to bring more cases than socially optimal.[12]

---

8. It is important to distinguish enforcement competition from regulatory competition for issuers. Enforcement competition usually results in more enforcement, while competition to regulate issuers in theory might lead to less regulation. For examples of articles supporting regulatory competition for issuers, see Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 50–55 (2003); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 *passim* (1998). *But see* John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531 *passim* (2001); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1395–1404 (1999).

9. *See, e.g.*, George J. Stigler, *The Optimum Enforcement of Laws*, 78 J. POL. ECON. 526, 531 (1970) ("[An enforcer] must be given more than a mandate . . . : It must have incentives to enforce the law efficiently.").

10. *See* Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. LEGAL STUD. 575, 577–78 (1997) (noting that private plaintiffs do not internalize the costs of enforcement, and do not internalize all the benefits of enforcement of socially desirable cases).

11. *See id.*; *cf.* Stigler, *supra* note 9, at 532 (noting that social costs include litigation costs incurred by innocent defendants).

12. In the context of securities regulation, the inquiry is complicated further by the fact that most private enforcement occurs through class actions. Because the class action aggregates the claims of thousands of plaintiffs, the potential payoff to the class action attorney who receives a percentage of the recovery can be very high. The class action attorney thus has a significant incentive to bring a securities class action that is greater than the incentive of any individual plaintiff. *See, e.g.*, Richard A.

In contrast to private enforcers, public enforcers are more motivated by their desire to act in the public interest since they are often charged with a public mission and have a culture that is sensitive to the public good. As a result, public enforcers might be more likely to weigh the social costs of a suit, even if the public enforcer does not directly bear such costs, and are therefore less likely to bring a questionable action where the social costs are high. A public enforcer also does not capture personal monetary gains when it wins a suit, reducing the incentive to bring cases that benefit the public enforcer but hurt society. Of course, those who work as public enforcers capture some private benefits in terms of job training, career development, and the excitement of bringing an enforcement case. But by and large, the public enforcer is motivated to further the social good.

One potential solution to the problem of private overenforcement is to give the public enforcer more authority over enforcement.[13] While private enforcers have no qualms about stretching the limits of a broadly worded statute, a public enforcer can exercise its discretion not to bring questionable cases, even when it could do so. The public enforcer may have particular expertise in the area that allows it to best make the decision whether an enforcement case is desirable. Rather than bringing cases with marginal merit, the public enforcer will exercise its discretion not to bring a case.

B. Proposals to Centralize Securities Enforcement

The economic argument for centralized enforcement has periodically been made in the context of securities enforcement. As demonstrated by the proposals discussed below, the push for centralization has mostly come in response to the rise of securities class actions, though active enforcement by state attorneys general has also been a factor.[14] This Section describes a number of academic proposals to centralize securities enforcement, ranging from increasing supervision of enforcers to consolidating the number of enforcers. These proposals conclude that securities enforcement should be controlled by an expert entity with the correct economic incentives.

Nagreda, *Class Actions in the Administrative State: Kalven and Rosenfield Revisited*, 75 U. CHI. L. REV. 603, 615–18 (2008) (discussing problem of class action overenforcement).

13. *See, e.g.*, William M. Landes & Richard A. Posner, *The Private Enforcement of Law*, 4 J. LEGAL STUD. 1, 38 (1975) ("A public monopoly of enforcement enables the public enforcer in effect to nullify particular laws, or particular applications of law, simply by declining to prosecute violators."); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 678 (1984) ("The optimal level of enforcement allows some violations to occur because the costs of stamping out these violations exceed the costs of the violations themselves.").

14. *See, e.g.*, Jonathan R. Macey, *The SEC at 70: Positive Political Theory and Federal Usurpation of the Regulation of Corporate Governance: The Coming Preemption of the Martin Act*, 80 NOTRE DAME L. REV. 951, 957–58 (2005) (describing efforts to preempt securities enforcement by state attorneys general).

In a provocative article published in 1994 prior to the passage of the Private Securities Litigation Reform Act (PSLRA),[15] which imposed various limits on private securities class actions, Joseph Grundfest argued that the SEC should increase its control of private securities enforcement.[16] Grundfest directed his proposal at SEC Rule 10b-5 (Rule 10b-5), which prohibits fraud in connection with the purchase or sale of securities.[17] This broadly worded anti-fraud provision has been read by the courts to confer an implied right of action to private plaintiffs,[18] and has long been perceived as a source of excessive private securities litigation.[19] Grundfest argued that the SEC had the power to disimply, at least in part, the implied right of private plaintiffs to bring class actions under Rule 10b-5. The SEC could restrict abusive private litigation by using its rulemaking power to more precisely define the elements of a Rule 10b-5 claim so that meritless cases would be screened out at the motion to dismiss stage.[20] By narrowing the scope of Rule 10b-5, the SEC could check some of the costs of excessive private litigation.[21]

---

15. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended at 15 U.S.C. §§ 77a-1 to 78u-5 (2000)).

16. Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961 (1994). Dan Kahan makes a similar argument with respect to federal criminal law, arguing that the power to interpret broadly worded federal criminal statutes should be centralized in the Department of Justice because of its expertise in making criminal law. *See* Dan M. Kahan, *Is* Chevron *Relevant to Federal Criminal Law?*, 110 HARV. L. REV. 469 (1996). Matthew Stephenson argues that administrative agencies rather than the courts are best suited to weigh the costs and benefits of whether an implied right of action can be inferred from a broadly worded statute. *See* Matthew C. Stephenson, *Public Regulation of Private Enforcement: The Case for Expanding the Role of Administrative Agencies*, 91 VA. L. REV. 93 (2005).

17. Rule 10b-5, which implements Section 10(b) of the Securities Exchange Act of 1934, reads in full:

> Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2011).

18. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975) (noting that Supreme Court had affirmed existence of implied private right of action under Rule 10b-5).

19. *See, e.g.*, *id.* at 739 ("[L]itigation under Rule 10b-5 presents a danger of vexatiousness different in degree from that which accompanies litigation in general."); Grundfest, *supra* note 16, at 969–71 (noting that private parties have financial incentives to bring meritless cases against deep-pocket defendants).

20. The scope of the implied cause of action could also be expanded, but Grundfest focuses more on the narrowing possibilities of his proposal. *See, e.g.*, Grundfest, *supra* note 16, at 1011–17.

21. Similar proposals have been made with respect to other areas of the law. *See, e.g.*, Kahan, *supra* note 16, at 519 ("*Chevron* has the potential to moderate criminal law by shifting lawmaking responsibility from individual U.S. Attorneys, who frequently advance bad statutory readings for

Implicit in Grundfest's argument is the idea that the SEC is a better securities enforcer than private parties because of its expertise with respect to the securities laws.[22] For Grundfest, the SEC embodies the ethos of the public enforcer who will exercise its discretion not to bring a case.[23] Under Grundfest's proposal, any narrowing of Rule 10b-5 would only apply to private actions without reducing the ability of the SEC to enforce,[24] centralizing more enforcement power in the SEC.[25]

To some extent, the U.S. Supreme Court has accepted the argument that the SEC is a superior enforcer. In a number of cases, the Court has limited the ability of securities class action plaintiffs to recover against secondary actors, such as the aiders and abettors of a securities fraud.[26] The Court's approach was at least partly influenced by the problem of private overenforcement.[27] The Court noted that its decisions do not affect the SEC's ability to bring enforcement actions against secondary actors,[28] implying that the SEC is a more trusted enforcer than private plaintiffs.[29]

While Grundfest's proposal focuses on the ability of the SEC to define substantive law in proposing greater centralization of enforcement, a more

---

political gain, to the Justice Department, which gets much less benefit from such readings and which is much more likely to internalize the costs of them."); *see* Landes & Posner, *supra* note 13, at 40 (noting that overenforcement by private enforcers can be limited by narrowing the scope of the law).

22. The image of the SEC as an independent, expert regulator has been present from the agency's inception. *See, e.g.*, JAMES M. LANDIS, THE ADMINISTRATIVE PROCESS 111 (1938); *see also In re* Am. Power & Light Co. v. Sec. & Exch. Comm'n, 329 U.S. 90, 112 (1946) (noting "experience and knowledge" of SEC); At Home Corp. v. Cox Commc'ns., Inc., 446 F.3d 403, 409 (2d Cir. 2006) (noting that the SEC is "uniquely experienced in confronting short-swing profiteering"). More generally, the vast power of administrative agencies has been justified by the idea that such delegation is necessary to utilize the expertise of nonpartisan bureaucrats. *See, e.g.*, Humphrey's Executor v. United States, 295 U.S. 602, 624–26 (1935); LANDIS, *supra* at 23.

23. Grundfest observes that in his experience as an SEC Commissioner, "the agency consistently sought to avoid instituting an enforcement action if it did not in good faith believe that the action would likely prevail on the merits." Grundfest, *supra* note 16, at 970.

24. *See, e.g.*, Grundfest, *supra* note 16, at 966 ("The decision would instead reallocate enforcement authority so that private rights of action would not necessarily reach as far as the Commission's own enforcement authority.").

25. Though Grundfest's proposal was made more than fifteen years ago, it remains influential. *See, e.g.*, William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market* (U. of Pa., Inst. for Law & Econ. Research, Working Paper No. 11-17, 2011), *available at* http://ssrn.com/abstract=1824324 (proposing that the SEC disimply presumption of reliance for fraud on the market class actions in favor of an actual reliance requirement).

26. *See* Stoneridge Inv. Partners, LLC. v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008); Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

27. *See Stoneridge*, 552 U.S. at 163–64 (noting that excessive private class actions might result in "rais[ing] the cost[s] of being a publicly traded company under our law and shift securities offerings away from domestic capital markets"); *Cent. Bank of Denver*, 511 U.S. at 189 (noting that the cost of private securities litigation may increase costs and uncertainty for companies).

28. Congress has made it clear that the SEC has the ability to enforce Rule 10b-5 against aiders and abettors. *See* Securities Exchange Act of 1934, 48 Stat. 891 (1934), *amended by* 15 U.S.C. § 78ff (1964).

29. *See Stoneridge*, 552 U.S. at 166.

recent proposal by Amanda Rose relies upon direct review of cases by the SEC to supervise private enforcement.[30] Rather than regulating private securities fraud litigation by narrowing the scope of Rule 10b-5 for private plaintiffs, Rose's proposal would subject private class actions to another level of review of the merits. Before filing a claim, the "putative private enforcer . . . could be required, prior to filing a Rule 10b-5 class action complaint in federal court, to submit it to the Commission for review."[31] The SEC could choose to allow the complaint to go forward, become involved in the case itself, or decide not to allow the private action to proceed.

As with the Grundfest proposal, the Rose proposal bases its argument for greater centralization on the assumption that overenforcement by private enforcers driven by profit is a significant problem.[32] The proposal would "rely on the . . . [SEC's] exercise of its expert discretion to protect against overdeterrence."[33] Again, the argument for centralization rests on the belief that the SEC's special expertise will enable it to enforce optimally, and in a way that is superior to private enforcers.[34] Though the Grundfest and Rose proposals relate primarily to restricting private enforcement, the arguments can be extended to other enforcers, as Rose does in a later proposal that argues for the consolidation of federal, state, and private enforcement authority in the SEC.[35]

Not all centralization arguments have focused on the merits of a public enforcer. Adam Pritchard has proposed that the power to enforce the anti-fraud provisions of the securities laws should largely be centralized with SROs such as stock exchanges with some oversight by the SEC.[36] Like Grundfest and Rose, Pritchard focuses on the incentives of enforcers. Stock exchanges have incentives to reduce securities fraud that affects the liquidity of markets. If a stock market is pervaded by fraud, fewer individuals will trade and exchange members will earn less in commissions.[37] Because exchanges bear the costs of

30. Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301 (2008).

31. *Id*. at 1354.

32. Rose, *supra* note 30, at 1331–47. Similar concerns about overenforcement have been raised with respect to private actions enforcing the antitrust laws. *See, e.g*., Daniel A. Crane, *Antitrust Antifederalism*, 96 CALIF. L. REV. 1, 38–43 (2008).

33. *See* Rose, *supra* note 30, at 1306.

34. It makes sense to initially question whether the SEC would be willing to significantly curtail private enforcement. The SEC has been openly supportive of private class actions. *See, e.g*., A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073, 1085 (2005) ("With a few minor exceptions . . . the SEC has sided with the plaintiffs' bar in the courts.").

35. *See* Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2176 (2010) ("[A] superior approach would be to consolidate the enforcement authority now shared between federal regulators, state regulators, and class action lawyers in a federal agency, such as the SEC, and to grant that agency exclusive authority to prosecute national securities frauds—while simultaneously enacting reforms to align that agency's enforcement incentives more closely with the public interest.").

36. *See* A.C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 976–81, 986 (1999).

37. *Id*. at 965–66.

excessive enforcement, they have a better incentive to check overenforcement than other enforcers such as class action attorneys.[38] Pritchard asserts that exchanges may even be superior enforcers to the SEC, which can be driven by political motives.[39]

Another interesting proposal for centralization comes from Amitai Aviram, who notes that securities enforcement tends to exacerbate the public's perception that fraud is associated with periods of economic turmoil.[40] Enforcers feel public pressure to bring securities enforcement cases when the economy is suffering, but doing so reinforces the tendency of the public to irrationally lash out at the securities industry during periods of economic decline. Aviram argues that an optimal enforcement policy should be counter-cyclical, that is, securities enforcers should be more restrained during times of economic crisis, checking the public's tendency to overreact.[41] Noting that the existence of multiple enforcers contributes to the problem of cyclical enforcement, Aviram suggests centralizing enforcement authority in the SEC, or allowing for multiple enforcers but giving an "expert grand jury" screening power over cases.[42]

Centralization arguments have also gained momentum in the policy world along with the rise of viable foreign securities markets and regulatory regimes.[43] Prior to the recent financial crisis, critics of the U.S. system pointed to foreign stock markets with centralized regulatory systems as offering more predictable (or friendlier) regulation to issuers than the decentralized system of enforcement in the United States.[44] These critics argued that centralization would be necessary to maintain the U.S.'s position in the global capital markets. A number of proposals were advanced to consolidate regulation, most notably the U.S. Treasury Department's *Blueprint for a Modernized Financial Regulatory Structure*.[45]

To summarize, proposals for centralization of securities enforcement are common and tend to make two arguments that draw on economic analysis of enforcement. First, some enforcers have incentives to overenforce the securities

38. *Id*. at 965–68.

39. *Id*. at 1018 (noting that threat of political prosecutions would be checked "by limiting the SEC to a secondary fraud enforcement role").

40. *See* Amitai Aviram, *Counter-Cyclical Enforcement of Corporate Law*, 25 YALE J. ON REG. 1 (2008).

41. *See id*. at 18–25.

42. *See id*. at 30–31.

43. *See, e.g.*, Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435, 1435 (2008) ("[F]oreign exchanges have developed liquid markets of their own, and now consistently attract over 90 percent of the world's initial public offerings . . . and half of all investor activity.").

44. COMM. ON CAPITAL MKTS. REGULATION, *supra* note 5, at 67 ("[T]he fragmented U.S. financial regulatory system has become increasingly filled with friction, and even dysfunctional.").

45. *See* U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 137–70 (2008).

laws. Second, more power to enforce should be centralized in an expert enforcer such as the SEC without such incentives.

C. The Competition Argument for Decentralized Enforcement

The response to the centralization argument, while not as fully developed, has generally made two points. First, an expert enforcer like the SEC is susceptible to capture by industry groups and subject to resource constraints, which may result in less vigorous enforcement. Second, multiple enforcers can compete with an expert enforcer and thus check underenforcement of the securities laws.

The narrative of the virtuous and competent public enforcer has long been challenged by public-choice theory, which posits that public officials do not always act to further the public good but act in pursuit of private benefits for themselves.[46] Proponents of public-choice theory argue that public officials are motivated by their own selfish interests, such as future employment in the private sector. When private interests capture public enforcers the result might be underenforcement.[47] For example, large corporate interests may influence regulators to trust the judgment of the industry rather than enforce the securities laws aggressively.[48] Public enforcement of the securities laws might be limited to cases against smaller firms without much clout.[49]

In addition, public enforcers may underenforce because they face resource limitations. While in theory exclusive public enforcement might be more optimal than relying on private enforcers, the reality is that limited resources will be allocated to public enforcement.[50] Private enforcement has a long history of being characterized as a "supplement" to public enforcement.[51]

---

46. Among the seminal works applying public-choice theory to regulation are George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) and Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976).

47. *See* Stigler, *supra* note 46, at 3 ("[R]egulation is acquired by the industry and is designed and operated primarily for its benefit.").

48. *See, e.g.*, Richard A. Posner, *Theories of Economic Regulation*, 5 BELL. J. ECON. & MGMT. SCI. 335, 341–43 (1974) (describing capture theory).

49. *See, e.g.*, Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers* (2009), *available at* http://ssrn.com/abstract=1333717 (finding evidence that SEC tends to target smaller broker-dealers).

50. Centralization proposals tend to downplay the reality of resource constraints. *See, e.g.*, Rose, *supra* note 35, at 2209 ("[I]n a world filled with public-spirited politicians, the budget afforded the federal securities fraud enforcer would, ipso facto, be set at an amount believed to be socially optimal.").

51. *See, e.g.*, Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 313 (2007) (noting that private actions are an "essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC)"); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) ("Private enforcement . . . provides a necessary supplement to [SEC] action."); James D. Cox et al., *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 738 (2003) ("Since the inception of the federal securities laws, the government's broad enforcement authority has been complemented by private causes of action."); *see also* Landes & Posner, *supra* note 13, at 36 ("[T]he budgets of public enforcement agencies tend to

Private attorneys general incentivized by economic payoffs will find it profitable to investigate and enforce the securities laws, enabling public enforcers to focus their resources on other tasks.

A number of commentators contend that decentralized enforcement leads to competition by enforcers that checks underenforcement.[52] John Coffee and Hillary Sale note the benefits of enforcement competition and observe that "state Attorneys General have played an aggressive role in prosecuting securities fraud and have pushed the SEC to be more vigorous in its own enforcement efforts."[53] Renee Jones points out that regulatory competition in enforcement can help reduce the problem of regulatory capture and make regulation more responsive to public concerns.[54] Academics have also argued that the vigorous system of securities enforcement in the United States, which includes state and private enforcement efforts, deters fraud and therefore contributes to the liquidity and transparency of its markets. [55]

D. The Problem with the Focus on Producing an Optimal Quantity of Enforcement

The current debate is limited in its explanatory power by its focus on achieving some optimal quantity of enforcement. Both proponents and critics of centralized enforcement tend to rely on the economic theory of enforcement, which focuses on the amorphous concepts of "over" and "under" enforcement or deterrence.[56] The obvious limit of this approach is the lack of meaningful criteria for measuring the amount of enforcement that is "optimal."[57]

---

be small in relation to the potential gains from enforcement as they would be appraised by a private, profit-maximizing enforcer.").

52. The idea that enforcement is optimized through competition between enforcers has been made in other contexts. *See, e.g.*, Richard S. Higgins et al., *Dual Enforcement of the Antitrust Laws, in* PUBLIC CHOICE & REGULATION 154 (Robert J. Mackay et al. eds., 1987) (concluding that competition among enforcers leads to efficient enforcement); Gary S. Becker & George S. Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J. LEGAL STUD. 1, 14 (1974) (observing that enforcers could compete).

53. John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 763 (2009); *see also* Macey, *supra* note 14, at 973 (noting that "capital markets will be weaker" if Congress preempted New York Attorney General's anti-fraud powers under Martin Act).

54. *See* Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L.J. 107, 121–26 (2005).

55. *See, e.g.*, John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 230 (2007) (arguing that "higher enforcement intensity gives the U.S. economy a lower cost of capital and higher securities valuations"); *see also* Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. ON REG. 253 (2007) (noting that the United States expends substantially more resources on public and private securities enforcement than other nations).

56. *See, e.g.*, Coffee & Sale, *supra* note 53, at 729 ("Does the United States overenforce? Or, does the rest of the world underenforce?"); Grundfest, *supra* note 16, at 971 & n.25 (noting the problem of overdeterrence: "When it comes to litigation, more is not necessarily better."); Rose, *supra* note 35, at 2194 ("[H]ow should lawmakers address the overdeterrence risk that flows from the possibility of legal error in securities fraud cases?"); Rose, *supra* note 30, at 1348 ("Private Rule 10b-5

Even though quantitative measures exist, they tell us a limited amount about the effectiveness of enforcement. For example, enforcement is often measured in economic studies through inputs such as the expenditure of enforcement resources,[58] or outputs such as cases filed or penalties collected.[59] A problem with focusing on expenditures is that enforcement resources may be misallocated or used inefficiently. Similarly, focusing on enforcement output can give a rough estimate of enforcement activity produced but does not provide much detail about the types of cases that are being brought.

Enforcement obviously differs in terms of quality, not just quantity. Thinking of enforcement as an output, much like a product, has the appeal of simplifying the analysis, but quantitative measures of enforcement do not capture the significant qualitative differences between enforcement cases. One can point to the large number of securities class actions that have been filed as evidence of wasteful overenforcement, but proponents might point to impressive results in the cases against companies such as Enron and WorldCom as demonstrating the merit of securities class actions. One can look to the large number of enforcement cases brought by the SEC as evidence that public enforcers are not asleep at the wheel, but critics might respond that most of these routine cases are trivial and that the SEC missed chances to bring more significant cases. Of course, quality is difficult to measure, and thus an alternative account must produce a workable measure of quality.

Focusing on the quantity of enforcement makes the case for centralizing securities enforcement artificially attractive. If enforcers are producing a uniform output, not much would be lost if enforcement power was centralized in one enforcer. Of course, the proponents of centralization do not actually think of enforcement efforts as being completely uniform, but their analysis of enforcement does little to differentiate between types of enforcement efforts. Understanding the role of multiple enforcers requires examining distinctions in their approaches to enforcement, which are shaped by significant institutional differences. The benefit of a decentralized system may not lie in the amount of enforcement generated, but rather in the quality of different enforcement cases brought by different enforcers.

---

enforcement may lead to overdeterrence . . . .").

57. *See, e.g.*, Colin S. Diver, *A Theory of Regulatory Enforcement*, 28 PUB. POL'Y 257, 264–71 (1980) (observing that deterrence is difficult to measure).

58. *See, e.g.*, Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 174 (1968) ("The more that is spent on policemen, court personnel, and specialized equipment, the easier it is to discover offenses and convict offenders.").

59. *See, e.g.*, GAO REPORT, *supra* note 1, at 31 (noting that "from 2003 through 2005, when [SEC] penalty amounts were comparatively high, a small number of cases with large penalties accounted for a disproportionate share of the total").

II.
RULE-ENFORCEMENT AND PRINCIPLE-ENFORCEMENT

This Part offers an alternative approach to understanding securities enforcement that draws a rough distinction between rule-enforcement and principle-enforcement. The essentials of this framework are simple. As with most areas of law, securities regulation is governed by both narrow rules that set forth technical requirements and broadly worded principles that can be interpreted to reflect public values. As a general matter, enforcing straightforward rules is less costly and controversial than enforcing nebulous principles. While the quality of enforcement can be distinguished in many other ways (for example, big versus small cases, high-profile versus low-profile cases, political versus nonpolitical cases, criminal versus civil cases), the distinction between rule-enforcement and principle-enforcement is rooted in a familiar literature and offers a richer portrait of enforcement than the traditional economic model, which treats enforcement as a uniform output.

A. Distinguishing Rules and Principles

Laws are often distinguished by their level of specificity. A rich literature discusses rules, standards, and principles as ways of classifying different legal provisions, partly based on their specificity, though these terms are not precisely defined.[60] This Article focuses on the sharper distinction between rules and principles because the distinction between rules and standards does not capture the moral element that is essential to principles.

In the literature, the most common distinction is drawn between rules and standards. Rules and standards are primarily distinguished by their level of specificity. Rules are more specific about what they require while standards tend to be more general.[61] A speed limit can be defined as a rule, "55 miles per hour," or as a standard, "drive at a reasonable speed."

As a result of their specificity, rules give more notice to the regulated, while standards require the regulated to exercise greater judgment in predicting what is required. The content of rules is largely determined ex ante through the administrative or legislative process while the content of standards is largely determined ex post through litigation with some supervision by the courts.[62]

60. The literature is too vast to summarize here. For a recent example of work that utilizes the distinction between rules, standards, and principles, see Jack M. Balkin, *Framework Originalism and the Living Constitution*, 103 NW. U. L. REV. 549, 553 (2009) ("Sometimes drafters choose to express themselves in clear rules, creating hard-wired features that are relatively determinate. Sometimes they use standards, and sometimes they articulate principles. These standards or principles can be broad, abstract, or vague.").

61. Of course, these terms can have different meanings in different contexts. For example, the Administrative Procedure Act defines "rule" broadly as a "statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy." 5 U.S.C. § 551(4) (2011).

62. *See, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J.

The specificity of rules serves to restrain the power of regulators to reach certain forms of misconduct that fall outside the scope of the rule. The generality of standards gives regulators the discretion to sanction conduct that might not have been specifically envisioned by lawmakers.[63]

Because standards are generally defined, courts and enforcers typically interpret standards by drawing on external factors or considerations.[64] A distinction has been drawn between standards defined by policy and standards that are defined by values, or principles.[65] A policy approach might rely upon considerations such as cost-benefit analysis, industry standards, or common practices in defining a standard such as reasonableness.[66] A speed limit that looks at reasonable speeds could be seen as a policy-driven standard that can be defined by looking at the average speed of drivers. Over time, such a speed limit might become more rule like as enforcers come to a consensus with respect to the level of speed that is reasonable.[67]

Certain standards might also be defined by background values or principles that are not easily defined through policy considerations such as cost-benefit analysis.[68] Such principles might reflect the fundamental values of various communities or society as a whole. Returning to our speed limit example, a speed limit in the form of a principle might prohibit driving at a dangerous speed. Applying the concept of dangerousness is likely to involve

---

557, 560 (1992) (distinguishing between rules and standards based on "the extent to which efforts to give content to the law are undertaken before or after individuals act") (emphasis omitted).

63. The tendency towards overbreadth has been discussed in the area of criminal law. *See, e.g.*, Samuel W. Buell, *The Upside of Overbreadth*, 83 N.Y.U. L. REV. 1491 (2008).

64. *See, e.g.*, Frank H. Easterbrook, *Foreword: The Court and the Economic System*, 98 HARV. L. REV. 4, 11–12 (1984) (observing that judges tend to rely on general concepts of fairness in ex post decision making).

65. I draw on Ronald Dworkin's discussion of this distinction. Dworkin explains:

> Most often I shall use the term "principle" generically, to refer to the whole set of these standards other than rules; occasionally, however, I shall be more precise, and distinguish between principles and policies. . . . I call a "policy" that kind of standard that sets out a goal to be reached, generally an improvement in some economic, political, or social feature of the community . . . . I call a "principle" a standard that is to be observed, not because it will advance or secure an economic, political, or social situation deemed desirable, but because it is a requirement of justice or fairness of some other dimension of morality.

Ronald M. Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14, 22–23 (1967).

66. For example, tort law is common law that is often defined in general terms, and can reflect a cost-benefit analysis approach. *See, e.g.*, John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 194 (1991) (noting that "tort law prices, while criminal law prohibits").

67. Inevitably, there is a tendency for the law to cycle between rules and standards. *See, e.g.*, Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 585–90 (1988) (describing how property law alternates between rules and standards).

68. *See* Cass R. Sunstein, *Problems with Rules*, 83 CALIF. L. REV. 953, 967 (1995) (defining principle as "a background notion that does not by itself cover an individual case, but is instead brought to bear on it as a relevant consideration"); *see also* Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 23 (2000) ("Standards . . . require legal decision makers to apply a background principle or set of principles to a particularized set of facts in order to reach a legal conclusion.").

more difficult value judgments than applying a concept of reasonableness.[69] Dangerousness cannot be determined solely by reference to a scientific calculation of average speeds but will require careful consideration of the violator's intent, which is often assessed by examining the context of the situation. Though some cases of dangerousness will be clear—such as deliberately driving down the wrong side of the street while intoxicated—other cases will be more difficult. Because it reflects a harsh disregard for public values, a finding of dangerousness will warrant a harsher sanction than a finding of driving at unreasonable speeds.

Throughout this Article, I refer to the enforcement of principles as shorthand for enforcement of a standard that is mainly interpreted in light of a principle rather than through the lens of policy. Put another way, the Article focuses on standards that look more like a dangerousness standard than a reasonableness standard. I focus on principles because the difference between rules and principles is starker than the difference between rules and standards that reflect policy.[70] While the distinction between rules and standards is based primarily on specificity, the distinction between rules and principles also reflects substantive differences in the values reflected by a legal provision. Though enforcing standards that reflect policy considerations can also raise controversy, the most difficult enforcement cases involve competing values. Moreover, in the particular context of the securities regulation literature, it has been common to refer to principles rather than standards.[71] My goal here is not to plow new ground in the rules/standards/principles discussion, but to highlight rough distinctions in the way that the securities laws are enforced. In distinguishing between qualitative types of enforcement, the difference between difficult and easy cases can be reflected by the difference between rules and principles.

B. Rules and Principles in Securities Regulation

As with most areas of the law, both rules and principles pervade the securities laws.[72] In recent years, the rhetoric of principles in securities regulation has become more prominent with the debate concerning whether securities regulation should primarily be principles-based or rules-based.[73] As

69. *See, e.g.*, Margaret H. Lemos & Alex Stein, *Strategic Enforcement*, 95 MINN. L. REV. 9, 26 (2010) (noting that the dangerousness standard is difficult to apply compared to a standard that focuses on outliers).

70. These distinctions are admittedly murky. *See* Kathleen M. Sullivan, *Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 58 n.231 (1992) (noting ambiguity of terminology).

71. *See, e.g.*, Coffee & Sale, *supra* note 53.

72. Tax law is another area where the enforcement of uncertain principles is of significant concern. *See, e.g.*, Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017, 1032–34 (2009).

73. Proponents of principles-based regulation believe that regulation should be broadly worded in a way that allows industry participants significant leeway in structuring their behavior. *See, e.g.*,

Lawrence Cunningham has observed, this project is likely unproductive because the reality is that U.S. securities regulation is a mix of both rules and principles.[74] An enforcement regime must consider that both rules and principles must be enforced.

It is easy to identify examples of rules relating to securities regulation. Specific rules require companies offering securities across state lines to file a registration statement,[75] require filings when a person acquires more than 5 percent of a registered company's securities,[76] require periodic filings by public companies,[77] require registration of broker-dealers,[78] set forth capital requirements for broker-dealers,[79] and require insiders of a registered company to disgorge profits from purchases and sales of the company's stock that occur within six months.[80] Such rules are fairly well defined and tend to reflect technical requirements of the regulatory system.

In recent years, there has been enforcement of a variety of principles in the context of securities regulation. For example, all securities enforcers enforce some variant of a fraud prohibition,[81] which has characteristics of a principle. The concept of fraud is defined at a high level of generality, and a finding of

---

Cristie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 AM. BUS. L.J. 1 (2008); Julia Black et al., *Making a Success of Principles-Based Regulation*, 1 LAW AND FIN. MARKETS REV. 191, 191 (2007) ("Principles-based regulation means moving away from reliance on detailed, prescriptive rules and relying more on high-level, broadly stated rules or Principles to set the standards by which regulated firms must conduct business.").

74. *See* Lawrence Cunningham, *A Prescription to Retire the Rhetoric of 'Principles-Based Systems' in Corporation Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411 (2007); *see also* William W. Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1055 (2003) ("GAAP of necessity always has and always will have mixed rules and principles."); *see also* Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985) (arguing that rules/standards dialectic is irresolvable).

75. *See* Securities Act of 1933 § 5, 15 U.S.C. § 77e (2011).

76. *See* Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (2011); Exchange Act Rule 13d-1, 17 C.F.R. § 240.13d-1(a) (2011) ("Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is [registered pursuant to section 78*l* of this title] . . . [and] is directly or indirectly the beneficial owner of more than 5 percent of such class shall, within 10 days after such acquisition, file with the Commission, a statement containing the information required by Schedule 13D.").

77. *See* Securities Exchange Act of 1934 § 13(a), 15 U.S.C. § 78m(a) (2011); Exchange Act Rule 13a-1, 17 C.F.R. § 240.13a-1 (2011) (requiring registered companies to file annual reports); Exchange Act Rule 13a-3, 17 C.F.R. § 240.13a-13 (2011) (requiring registered companies to file quarterly reports).

78. *See* Securities Exchange Act of 1934 §15(a)(1), 15 U.S.C. § 78o (2011).

79. *See* Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2011).

80. *See* Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2011).

81. *See, e.g.*, Securities Exchange Act of 1934 § 32 (federal criminal securities fraud); 18 U.S.C. §§ 1341, 1343 (2011) (federal wire and mail fraud criminal statutes); The Martin Act, 23-A, N.Y. GEN. BUS. LAW §§ 352–353 (Consol. 2011) (New York securities fraud statute); Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2011) (federal civil securities fraud); *FINRA Rule 2020: Use of Manipulative, Deceptive, or Other Fraudulent Devices*, FIN. INDUSTRY REG. AUTHORITY, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5513 (last visited Nov. 28, 2011) (SRO Prohibition).

fraud requires a value judgment as to whether a misrepresentation was made with fraudulent intent. An assessment of fraud is difficult to reduce to a policy judgment but requires an assessment of conduct that can vary greatly based on the perspective of the enforcer. In other words, the anti-fraud principle looks more like a dangerousness standard than a reasonableness standard.

Though much principle-enforcement involves claims of fraud brought against an issuer who has inflated its stock through a fraudulent statement, principles have been relevant in many other contexts. Major cases have been brought against research analysts, broker-dealers, and mutual fund managers for misconduct that implicated not only an anti-fraud principle, but broader principles of fiduciary duty and unjust enrichment.[82] Such cases involved not only citation to federal law, but also application of principles reflected by SRO regulation and state law.[83]

Of course, there are many regulatory provisions that do not fit neatly within the dichotomy of rules and principles. Many legal provisions fall across a vague continuum. The purpose of this exercise, however, is not to comprehensively classify the securities laws as rule or principle, but to highlight two somewhat distinct styles of enforcement.

C. Distinguishing Rule-Enforcement and Principle-Enforcement

Rule-enforcement and principle-enforcement might be distinguished on at least two related grounds. The first is cost of enforcement. Rules tend to be less costly to enforce than principles because their meaning is less contestable by design. The second is the controversy of enforcement. Enforcement of rules mostly involves straightforward technical issues, while enforcement of principles more often involves contested values.

1. Cost of Enforcement

In an economic analysis of rules and principles, Louis Kaplow observes that from a regulator's point of view, the cost of a rule is incurred ex ante when the rule is promulgated, while the cost of a principle is incurred ex post when it is being enforced.[84] This basic distinction serves as a basis for thinking about the difference between rule-enforcement and principle-enforcement.

---

82. For a description of some of these cases, see James J. Park, *Rule 10b-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 315 (2010) (describing increased use of unjust enrichment principle in Rule 10b-5 cases); James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625, 651–62 (2007) (describing cases against research analysts, broker-dealers, and mutual fund managers).

83. *See* Park, *The Competing Paradigms of Securities Regulation*, *supra* note 82, at 651–62.

84. Kaplow, *supra* note 62, at 562–63 ("Rules are more costly to promulgate than standards because rules involve advance determinations of the law's content, whereas standards are more costly for legal advisors to predict or enforcement authorities to apply because they require later determinations of the law's content.").

a. The Costs of Rule-Enforcement

The cost of a rule is typically incurred up front. In other words, the promulgator of the rule bears most of the costs of lawmaking rather than the enforcer. Because they impose specific requirements, rules must be carefully thought through both in terms of their content and form. A poorly crafted rule can cause significant havoc. Without the flexibility that characterizes principles, there may be little wiggle room for the regulated to deal with a problematic rule. Understanding the costs and benefits of the rule and its relationship to other rules is thus essential when drafting the rule.

While rules can be complex,[85] if a rule is well crafted, there should be little debate about its meaning when enforced. Though there can be complicated threshold issues as to whether a rule applies,[86] in many cases it is clear that the rule applies, and the enforcer need only answer a simple question when enforcing a rule. Has the brokerage firm met its capital requirements? Is the securities offering registered? Is the broker registered? Has a company preserved its books and records for the required time period? Have shares in an initial public offering been distributed to prohibited individuals?

For example, if a public company fails to follow basic reporting requirements, the legal rule that the enforcer is seeking to apply should be relatively straightforward. As Judge Henry Friendly once observed, "There is nothing vague or indefinite in the requirement for filing an annual report . . . ."[87] Once it is established that the rule is applicable, the content of what the rule expects from the company should be clear, and the only question is whether the envisioned set of facts triggering a rule violation is present.[88] If a rule is somewhat unclear, a regulator can clarify the rule or assert its authority to establish that its interpretation of that rule is authoritative.

---

85. *See, e.g.*, Louis Kaplow, *A Model of the Optimal Complexity of Legal Rules*, 11 J.L. ECON. & ORG. 150, 151 (1995) ("[W]hen rules are more complex, an enforcement authority typically will have to expend additional resources to determine whether a violation occurred or the severity of the violation.").

86. For example, the federal securities registration requirement only applies to a "public offering," Securities Exchange Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (2011), which requires an inquiry into the nature of the offering that can be complicated. *See, e.g.*, S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953) (discussing scope of private offering exemption). However, if it is clear that an offering is public and no other exemption applies, it is clear that it must be registered. Securities Exchange Act of 1933 § 5, 15 U.S.C. § 77e (2011). Similarly, in some cases, the threshold question of whether an entity is acting as a broker can be complex. *See, e.g.*, 1 NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION § 5.02 (4th ed. 2011) (summarizing law used to determine whether a firm is a broker-dealer).

87. United States v. Guterma, 281 F.2d 742, 746 (2d Cir. 1960) (Friendly, J.).

88. *See, e.g.*, Dworkin, *supra* note 65, at 25 ("Rules are applicable in an all-or-nothing fashion. If the facts a rule stipulates are given, then either the rule is valid, in which case the answer it supplies must be accepted, or it is not, in which case it contributes nothing to the decision."); Korobkin, *supra* note 68, at 32 ("When disputes arise, they can be resolved at lower cost by rules, because adjudicators need only determine whether the triggering facts are present or absent—the legal consequences of different facts have already been determined.").

Because rules generally target misconduct that tends to be repeated in similar ways over time,[89] enforcers can build a reservoir of knowledge and practical expertise that improves their likelihood of prevailing in litigation when enforcing the rule. The enforcer can develop templates of commonly used pleadings, administer training programs for staff attorneys, and invest in resources that will decrease the average cost of enforcement. Rule-enforcement can be reduced to a routine with low administration costs.

b. The Costs of Principle-Enforcement

In contrast to rules, principles require less investment up front but are more costly to enforce.[90] Because they are broadly worded, the promulgators of the principle may expect that others can sort out the details. In other words, the drafters of a principle defer the costs of lawmaking to future enforcers. Some principles are meant to convey fundamental values on which there is wide agreement—at least in the abstract. Other principles are deliberately ambiguous because of the need for legislative compromise.[91]

Broadly worded principles are more susceptible to disputes about meaning and application than rules. The content of a principle may not be clear because it can be applied to a wide range of envisioned and unenvisioned facts. Thus, the regulator must exercise a significant amount of judgment in targeting conduct with principle-enforcement. The target of enforcement can argue that the regulator is unfairly expanding the principle beyond its intended meaning. Additionally, because it often requires establishing an element of culpable intent, principle-enforcement is intensely fact specific, requiring significant amounts of investigation and case development. Without a smoking gun or confession, enforcers must base their case on circumstantial evidence that can be disputed.

Although the application of principles seems simple because principles apply to a wider range of conduct than rules, the cost of developing a viable principle-enforcement case is typically much higher than developing a rule-enforcement case. Principle-enforcement often relates to a unique set of facts. As a result, the enforcer must essentially start anew with every case, and thus, the experience from past cases may not necessarily reduce the cost of enforcement. In order to succeed, enforcers will need to assemble evidence of culpable intent, which often requires costly and timely review of voluminous materials.

89. *See* Kaplow, *supra* note 62, at 573.

90. *See, e.g.*, Kaplow, *supra* note 62, at 570 (noting that enforcement "is costly, with the cost being greater if a standard governs because the adjudication will also require giving content to the standard"); *id.* at 577 ("Rules cost more to promulgate; standards cost more to enforce.").

91. *See* Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 640–41 (2002) ("Ambiguity can, however, also be the result of a need to compromise in order to accumulate a majority (or a veto-proof supermajority) in support of legislative action.").

2. Controversy of Enforcement

Rule-enforcement and principle-enforcement can also be distinguished in terms of the controversy raised by their enforcement. By controversy, I mean disagreement about the appropriateness of applying the rule or principle to the conduct in question. Controversy and cost differ in that cost is incurred in developing a case while controversy is spurred after a case has been brought. Rules and principles are different in the enforcement controversy they spur because they tend to have different expressive meanings.[92] Rules often reflect technical requirements that reflect greater consensus while principles often reflect values that can be controversial in application.

a. The Meaning of Rule-Enforcement

At least in the context of securities regulation, rules mostly reflect technical regulatory requirements.[93] The substance of rules is defined by an expert regulatory agency, the SEC, through a rulemaking process that is often subject to cost-benefit analysis.[94] Because of the risks of passing a specific requirement that can impose substantial burdens on companies, rules tend to reflect consensus between the regulator and the industry. With such consensus, the enforcement of a rule is less likely to raise controversy.

Once the facts establishing a rule violation are known, it is unlikely that the violator has many legal avenues to resist enforcement.[95] The violator can deny the violation or find some excuse that mitigates the penalty, but it is the rare case where the violator can argue against the legitimacy of enforcing the rule. Indeed, it is possible that the violation is simply a mistake and the violator wants to comply with the rule.

92. Many commentators have noted that law has expressive value. For a summary of the literature, see Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363 (2000). For a discussion of expressive theory in the context of regulatory frameworks, see Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1, 66–72 (1995).

93. This also tends to be true outside of the securities regulation context. *See, e.g.*, Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 271 (1974) ("[P]art of the process of reducing a standard to a set of rules is the elimination of value-laden terms."); Kaplow, *supra* note 62, at 598 ("The implicit scenario is one in which a legal command, if promulgated as a rule, will be given technical detail by lawyers or other relevant experts—whereas standards will be given content through decisions of lay juries, who will rely on common understandings (rather than on, say, expert testimony).").

94. The Administrative Procedure Act requires notice and comment for proposed rules. *See* 5 U.S.C. § 553(b)–(c) (2011). The SEC is also required by the National Securities Market Improvement Act of 1996 to assess the impact of its rules on "efficiency, competition, and capital formation." *See* National Securities Markets Improvement Act of 1996, 106 Pub. L. No. 104-290, 110 Stat. 3416, 3425 (1996) (codified as amended in scattered sections of 15 U.S.C.).

95. *See, e.g.*, Sunstein, *supra* note 68, at 962 ("When rules are operating, an assessment of facts, combined with an ordinary understanding of grammar, semantics, and diction . . . is usually sufficient to decide the case.").

In light of their technical content, rule violations do not necessarily reflect morally blameworthy conduct. Rules are commonly violated inadvertently because of their complexity or because of the difficulties of operating a large organization. For example, if a broker-dealer inadvertently fails to set aside a certain amount of capital, a rule is violated,[96] but it is difficult to say that the broker-dealer has necessarily acted in a morally reprehensible fashion.[97] The rule violation may say something about the broker-dealer's competence in complying with the regulatory scheme, but it does not necessarily mean that the broker-dealer has run afoul of deeply held societal values.

An advantage of rule-enforcement is that it can be framed in technical terms to avoid controversial moral debates. Rather than expressing moral outrage at industry conduct, a rule-enforcer can simply assert its authority to enforce the rules of the game.[98] Rule-enforcement may also be less controversial because it can be linked to a fundamental goal of any enforcement system, deterrence.[99] Notice is an essential part of generating deterrence in that it allows the enforcer to clearly signal the probability of enforcement and its cost. Consistent rule-enforcement provides notice to the industry about the probability of enforcement and the cost of enforcement, and thus contributes to the goal of deterrence. By framing an enforcement case as merely a technical issue of deterring rule violations, the enforcer can avoid difficult and controversial value judgments.[100]

Moreover, because rule violations usually reflect technical rather than moral lapses, rule-enforcement is less likely to involve the imposition of significant penalties than principle-enforcement. Large penalties are appropriate in response to blameworthy conduct that deserves a sanction, while modest administrative fines are more likely to reflect the cost of business.[101] Indeed, rule-enforcement may involve no more than an injunction or consent decree that requires the violator not to violate the rule going forward. Instead of disputing the application of the rule, the violator may simply settle the violation. Rule-enforcement can thus be administered in a way that minimizes controversy.

---

96. *See* Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1 (2011).

97. *See, e.g.*, Harvey L. Pitt & Karen L. Shapiro, *Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 246–48 (1990) (noting that violation of net capital rules does not deserve severe sanction).

98. Indeed, many rule violations can be adjudicated by the enforcer's own administrative courts. *See* Securities Exchange Act of 1934 § 21B, 15 U.S.C. § 78u-2 (2011) (authorizing SEC to impose civil penalties for certain violations in administrative proceedings).

99. The economic theory of enforcement focuses on deterrence. *See, e.g.*, A. Mitchell Polinsky & Steven Shavell, *The Economic Theory of Public Enforcement of Law*, 38 J. ECON. LITERATURE 45 (2000); Shavell, *supra* note 10, at 582–84, 594–97 (focusing on deterrence as the social benefit of private suits).

100. *See, e.g.*, Dan M. Kahan, *The Secret Ambition of Deterrence*, 113 HARV. L. REV. 413 (1999) (arguing that criminal law utilizes deterrence language to dampen controversial value disputes).

101. *See, e.g.*, Robert Cooter, *Prices and Sanctions*, 84 COLUM. L. REV. 1523 (1984) (distinguishing between sanctions that are punitive and prices that are simply costs).

b. The Meaning of Principle-Enforcement

Principle-enforcement, in contrast to rule-enforcement, can draw enforcers into controversial value debates. While there may be consensus as to a principle in the abstract, there can be significant disagreement about the values that should guide the application of the principle. Different enforcers will come to different conclusions as to what a principle means and what values it should reflect.

Principle-enforcement often requires bringing cases involving difficult value judgments in complex contexts. For example, accounting fraud requires evaluating the preparation of financial statements in reference to broadly worded accounting standards.[102] Even if it is clear that the financial report was false, a finding of fraud requires an additional inquiry relating to scienter—that is, fraudulent intent—an element that is principle-like in that it is broadly defined and reflects conduct that is morally blameworthy.[103] Under Rule 10b-5, the same misrepresentation that would trigger liability if made with scienter would not trigger liability if made without scienter. Courts have struggled with defining scienter with any specificity,[104] and there can be reasonable disagreement as to whether a certain set of facts supports a finding of scienter. One can thus expect significant enforcement variance with respect to principle-enforcement.

Because principle-enforcement often involves allegations of bad intent, the defendant has greater reason to fight. Admitting the violation may have significant reputational consequences. The enforcer will be more likely to seek substantial sanctions for violation of a principle than for a simple rule violation. As a result, the principle violator can have greater economic incentives to fight enforcement by vigorously litigating the case than if caught breaking a rule.

Also, it is more likely that a determined defendant can resist principle-enforcement.[105] A defendant will often be able to argue that given the complexity of the transaction, he did not know that he was doing something wrong. The defendant can claim that given the vagueness of the principle, he did not know that the conduct in question was prohibited. While the principle violator may not succeed in persuading the regulator to drop the case,

102. Nor does compliance with GAAP necessarily immunize one from liability for violating a broader principle. *See* United States v. Simon, 425 F.2d 796, 806–07 (2d Cir. 1969).

103. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (requiring finding of scienter in Rule 10b-5 cases); *see also* Samuel W. Buell, *Novel Criminal Fraud*, 81 N.Y.U. L. REV. 1971, 1996–2014 (2006) (discussing centrality of consciousness of wrongdoing in cases involving novel fraud).

104. Courts tend to resort to somewhat arbitrary heuristics in determining whether scienter exists. *See, e.g.*, Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 85 (2002); Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903, 923–24 (2002).

105. Of course, there will be situations where a defendant is pressured into a settlement to avoid adverse publicity and the risk of a significant sanction.

resistance might lead to a trivial settlement that reflects less serious conduct than initially alleged.[106]

Principle-enforcement can create additional controversy by requiring the enforcer to take sides on value disagreements with little consensus. Should a principle be enforced against conduct that is widely seen as "industry practice"? Is the practice in question greedy and unethical, or is it simply what market participants do in a competitive industry? Did the CEO act to defraud investors, or was he simply optimistic about the company's prospects? If the victim of the scheme is a sophisticated investor, is it appropriate to protect an individual who has the tools to assess the risk of the transaction? Such questions are difficult to answer and may never be completely resolved by a uniform policy.

An enforcer may also be wary of the moral element of bringing a fraud case against a defendant.[107] The open-ended nature of the fraud prohibition is justified as a way of giving regulators the ability to target a wide array of morally reprehensible conduct.[108] But some enforcers may not want to enter the realm of moral debate in pursuing principle-enforcement. It might be safer to bring lesser charges of rule violations that can be characterized in technocratic terms.[109]

---

106. The defendant can then characterize the violation as minor, as noted by a defense attorney:

> It is the cosmetics, particular words and terms of disclosure, that have a great effect on public reaction. . . . The SEC may typically charge in an enforcement action: "This is a fraudulent course of conduct that operated as a fraud and deceit because the financial statements were false and misleading." If the corporation is handling the matter, it can take the same facts and make a public disclosure that will probably satisfy all the disclosure statutes. But the corporation can word it a little differently: "This was a course of business that did not adequately comply with the disclosure requirements of the law, because the disclosures previously made were insufficient and inadequate in a certain respect."

Arthur F. Mathews, *The Role of Outside Counsel*, 61 N.C. L. REV. 483, 486 (1983).

107. *See, e.g.*, Buell, *supra* note 103, at 2025 ("The presence of badges of fraud in a novel fraud case might display moral fault.").

108. *See, e.g.*, Kahan, *supra* note 16, at 475 ("The concept of fraud is incompletely specified by design. It was devised by equity courts as a catchall for any species of grossly immoral and deceptive conduct that evaded recognized common law norms.").

109. The importance and difficulty of establishing scienter are illustrated by contrasting the SEC's 2010 enforcement cases against Goldman Sachs and Citigroup. In the Goldman Sachs case, the SEC alleged Goldman Sachs misrepresented that securities included in a synthetic collateralized debt obligation (CDO) would be selected by an independent party. Complaint at ¶ 70, Sec. & Exch. Comm'n v. Goldman Sachs & Co., 10-CV-3229 (S.D.N.Y. Apr. 16, 2010). In the Citigroup case, the SEC alleged that Citigroup misstated its exposure to the sub-prime market by thirty-nine billion dollars. Complaint at ¶ 1, Sec. & Exch. Comm'n v. Citigroup, 10-cv-1277 (D.D.C. July 29, 2010).

Though both actions involved allegations of significant misrepresentations to investors, the Goldman Sachs and Citigroup cases involved different legal theories. The Goldman Sachs case alleged violations of section 17(a) of the Securities Act, which prohibits fraud in connection with the offer or sale of a security, and Section 10(b) of the Securities Exchange Act and SEC Rule 10b-5, which prohibit fraud in connection with the purchase of sale of a security. *See* Goldman Compl., *supra* at ¶¶ 67–74. In contrast to the Goldman Sachs case, the case against Citigroup was based primarily on violations of Section 17(a)(2) of the Securities Act, which does not require a finding of fraudulent intent. *See* Aaron v. Sec. & Exch. Comm'n, 446 U.S. 680 (1980) (holding that violations of sections 17(a)(2) and 17(a)(3) can be established without a finding of scienter); Goldman Compl., *supra* at ¶¶

Of course, there will be cases of principle-enforcement that are not controversial. Conduct can be so egregiously wrong that there is no question a principle has been violated. Punishing certain frauds such as Ponzi schemes is uncontroversial because such conduct is undisputedly fraudulent. When a principle has been clearly violated, the controversy of enforcing the principle will be similar to that of enforcing an established rule. Indeed, many principle-violations will also clearly violate a rule, and it will be less controversial to bring a case when both a rule and a principle have been violated.

Unlike rule-enforcement, principle-enforcement can be more difficult to link to deterrence because of the sui generis nature of many principle-enforcement cases. Since principles often require complex, individualized assessment of a wide variety of considerations, it can be harder to anticipate patterns of enforcement for a principle than for a rule. While some conduct is clearly wrongful based on past application of principles, much of the conduct targeted through principle-enforcement lies in gray areas where the regulator cannot conclude the conduct is unlawful without intensive analysis of the facts and law. As a result, industry participants engaging in questionable conduct may rationalize that their situation is different from previous cases of principle-enforcement. Principle-enforcement thus may not do much to clarify the law and give notice as to the probability of future enforcement.

On the other hand, if principles are regularly enforced, industry participants may be prompted to act preemptively in assessing their conduct.[110] Complying with principles requires a significant amount of judgment on the

---

67–74.

It is worth noting that Goldman Sachs fought to negotiate a settlement that did not involve a fraud allegation. Goldman Sachs persuaded the SEC to agree to a $550 million settlement that did not include the Section 10(b) and Rule 10b-5 violations, but did include a section 17(a) violation. *See* Final Judgment as to Defendant Goldman, Sachs & Co., SEC v. Goldman Sachs & Co., 10-CV-3229 (S.D.N.Y. 2010); Kara Scannell & Susanne Craig, *SEC Split Over Goldman Deal*, WALL ST. J., July 17, 2010, at A1. Because a violation of section 17(a)(1) can only be found if there is scienter, the SEC could still claim that the settlement involved a claim with a scienter element. *See, e.g.*, Scannell & Craig, *supra* (describing the meaning of SEC's decision to drop section 10(b) fraud claim against Goldman).

Less than two weeks after the Goldman Sachs settlement, the SEC settled the Citigroup case, requiring Citigroup to pay a seventy-five million dollar penalty. *See* Randall Smith, *Parsing the Settlement at Citi*, WALL ST. J., Aug. 2, 2010, at C3. The Citigroup case specifically only referenced section 17(a)(2) rather than section 17(a) in its entirety. Citigroup Compl., *supra* at ¶ 2. Perhaps the SEC was emphasizing that the Goldman settlement included a provision with a scienter element by settling a case that did not. Relative to the Goldman Sachs settlement, Citigroup paid a small penalty, signaling that the misconduct was not as serious as Goldman's conduct. After the Citigroup settlement, it was reported that analysts debated the meaning of the settlement, asking whether the settlement involved fraud allegations. *See* Smith, *supra*.

110. Compliance attorneys might influence institutions to develop norm-based compliance programs. *See* Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 960 (2009). Enforcement might influence institutions to pay closer attention to social norms. *See* Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585, 586 (1998) (arguing that laws can change individual values and cause people to internalize social norms).

part of regulated individuals and entities. Rather than simply applying a straightforward rule, compliance requires predicting how a regulator might apply the principle to a novel course of conduct.[111] A danger, though, of principle-enforcement is that it could create a chilling effect where parties will be overly cautious for fear that they will be punished for acts that a regulator determines ex post is misconduct.[112]

Principle-enforcement tends to be more costly and controversial than rule-enforcement, requiring enforcers to take risks in developing and pursuing a case.

D. Enforcement Strategy

The distinction between rule-enforcement and principle-enforcement suggests that different enforcers might choose different enforcement strategies. Moreover, enforcers will differ in the values they seek to express through principle-enforcement.

Enforcers will vary in the mix of rule-enforcement and principle-enforcement cases they bring. An enforcement strategy emphasizing rule-enforcement would be attractive to an enforcer seeking to bring a high quantity of low-impact, low-cost cases. Enforcers may choose not to enforce principles because they seek to conserve costs and maximize the number of cases they bring. An enforcement strategy emphasizing principle-enforcement would be attractive to an enforcer seeking to bring a small quantity of high-impact, high-cost cases. Such enforcers may not have the resources to bring a large number of cases, but are willing to invest resources and endure controversy to pursue a few high-impact cases.

The broadly worded nature of principles will likely create greater variance in the enforcement of principles than there is with rules. Some enforcers will interpret principles broadly to aggressively challenge industry misconduct. Other enforcers will defer to industry standards and interpret principles narrowly so they function more like rules. Because their application depends so much on how the facts are developed, principles can be enforced very differently based on the enforcer bringing the case.[113]

Enforcers that wish to avoid or minimize the cost and controversy associated with principle-enforcement can enforce principles selectively. For example, an enforcer may choose to enforce principles only against parties without the resources to fight. In doing so, an enforcer can minimize the cost

111. *See, e.g.*, William L. Cary, *Corporate Standards and Legal Rules*, 50 CALIF. L. REV. 408, 408 (1962) (urging attorneys to advise corporate clients to anticipate how standards will be applied).

112. *See, e.g.*, John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965 (1984) (noting that uncertain legal standards lead to economic incentives to over- or undercomply).

113. Indeed, principles are susceptible to enforcement by multiple actors. *See, e.g.*, Kaplow, *supra* note 62, at 611 ("[S]tandards can be applied by many agents.").

and controversy of enforcing principles. On the other hand, aggressive enforcers may only choose to focus on enforcing principles against high-profile targets. Such enforcers are willing to take on more risk in investing resources to bring a case with significant impact.

Finally, some enforcers may go through the motions of enforcing principles but in a way that treats principle violations as akin to rule violations that only merit nominal sanctions. While technically enforcing the principle, without significant sanctions, the action can be dismissed as a relatively trivial administrative cost. Even though such an enforcer is technically enforcing a principle, it cannot be considered a true enforcer of principles.

III.
THE TENDENCIES OF SECURITIES ENFORCERS

Enforcers differ in the mix of rule-enforcement and principle-enforcement they choose to utilize. Some enforcers are better able to take on the cost and controversy of principle-enforcement than others. Enforcers are also influenced by different values in enforcing principles. Examining these tendencies provides insight into the present landscape of securities enforcement. This Part examines different types of enforcers—industry, regulatory, public values, and entrepreneurial—and describes their enforcement approaches in light of the distinction between rule-enforcement and principle-enforcement.

A. Industry Enforcers: Self-Regulatory Organizations

A significant amount of securities regulation has been delegated to Self-Regulatory Organizations, or SROs.[114] SROs under the supervision of the SEC have primarily regulated trading on stock exchanges and the practices of broker-dealers.[115] Recently, the responsibility for regulating certain aspects of exchanges and registered broker-dealers were consolidated into one SRO, the Financial Industry Regulatory Authority (FINRA).[116] SROs are active in securities enforcement, typically policing market activity and broker-dealer misconduct.[117]

SROs have mixed incentives in pursuing enforcement. While somewhat independent, SRO enforcement divisions are funded by the members of the

114. For a survey of the role of SROs in international securities regulation, see Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. CAL. L. REV. 1239 (2007).

115. Broker-dealers are required to be members of FINRA in order to be involved with securities transactions. Securities Exchange Act of 1934 § 15(b)(8)-(9), 15 U.S.C. § 78o(b)(8)–(9) (2011).

116. For a history of the SROs, see Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 159–70 (2008).

117. *See, e.g.*, David P. Doherty et al., *The Enforcement Role of the New York Stock Exchange*, 85 NW. U. L. REV. 637, 647–48 (1991) (describing enforcement activities of New York Stock Exchange).

SRO. SROs have an incentive to minimize enforcement budgets, especially during difficult economic periods.[118] Furthermore, aggressive, high-profile enforcement efforts may cause embarrassment to the industry by highlighting misconduct.[119] On the other hand, SROs have an incentive to enforce because business is likely to suffer if there is a significant perception that broker-dealers and stock exchanges can engage in wrongdoing without sanction.

The combination of limited resources and mixed incentive to enforce suggests that SROs are more likely to emphasize rule-enforcement over principle-enforcement.[120] Rule-enforcement is attractive to an SRO because it can be administered at low cost and is unlikely to cause significant controversy. In contrast, if an SRO were to focus on developing a complex principle-enforcement effort, it might spend a disproportionate amount of its limited resources in prosecuting a case that could cause significant reputational harm to the industry. Indeed, SRO enforcement tends to involve relatively small fines,[121] an indication that many SRO cases involve simple rule violations.

Because of its close ties to industry, SRO principle-enforcement is likely to reflect industry values. Indeed, SRO rules emphasize industry standards of enforcement. For example, FINRA Rule 2010 requires FINRA members to act in accordance with "high standards of commercial honor and just and equitable principles of trade."[122] When enforcing principles such as Rule 2010, SROs will look to the expectations of the industry in assessing whether to bring a case. SRO enforcement is likely to be passive rather than active when it comes to misconduct by influential industry members.[123] It is unlikely that an SRO

---

118. *See, e.g.*, Gadinis & Jackson, *supra* note 114, at 1260 ("[I]n periods of financial hardship, a private corporation seeking to minimize its expenses may look into cutting its regulatory budget, possibly right at the moment that market conditions would justify a high-level intervention more than ever.").

119. *See, e.g.*, Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509, 1518 (1997) ("From the perspective of an exchange, the optimal image to convey to the public is that no violations of its rules occur, an image that is blunted by the discovery of violations, even if the violator is found and punished.").

120. SRO listing requirements are especially rule-like. *See, e.g.*, Coffee & Sale, *supra* note 53, at 769 ("[SRO listing rules] tend to be of a check-the-box nature—i.e., classic 'rules' with no hint of principles lurking beneath the surface.").

121. FINRA collects a modest amount of fines relative to other enforcers. *See* Joseph A. Giannone, *Analysis: Fines by Wall St Cop on Pace to Fall this Year*, REUTERS, July 29, 2010, *available at* http://www.reuters.com/article/2010/07/29/us-finra-enforcement-analysis-idUSTRE66S54R20100729 (noting that FINRA collected fifty million dollars in fines in 2009 and is on pace to collect less in 2010). Small fines are evidence of a focus on rule-enforcement cases that are likely to settle quickly for low sums. *See also* Eugenio J. Cárdenas, *Self-Regulation by the Mexican Stock Exchange: A Promising Path Toward Developing Mexico's Securities Market?*, 47 STAN. J. INT'L L. 199, 214 (2011) (noting "that self-regulation . . . is largely procedural. . . . [T]he sanctions mostly relate to causes like untimely and incomplete filing of periodic financial . . . disclosure . . . .").

122. *See FINRA Rule 2010: Standards of Commercial Honor and Principles of Trade*, FIN. INDUSTRY REG. AUTHORITY, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504 (last visited Nov. 28, 2011).

123. The SEC's investigation of the enforcement efforts of the National Association of Securities Dealers, Inc. ("NASD"), which has responsibility for supervision of the Nasdaq Stock

enforcer will go on a moral crusade and apply principles to aggressively change industry conduct.[124] Instead, SROs will more likely utilize their rulemaking power to address new forms of systemic misconduct. By framing misconduct as a technical rule violation, SROs can help ensure that the violation is seen as an internal industry dispute rather than something worthy of public attention.

Because they are funded by industry and are likely to be influenced by industry values, SROs have little incentive to focus on principle-enforcement and are most likely to pursue rule-enforcement.

B. A Regulatory Enforcer: The SEC

The SEC is the primary securities regulator. It is arguably independent of the securities industry, well funded, and largely motivated by the public good in enforcing the securities laws. As a result, we can expect that the SEC will do more to emphasize principle-enforcement than SROs. On the other hand, the SEC has institutional constraints that can prevent it from adequately pursuing principle-enforcement. The sheer size of the SEC's bureaucracy and the SEC's role as an expert regulator may encourage it to focus more on rule-enforcement. Thus, at times, the SEC may not be able to provide adequate securities enforcement.

Market, is an example where an SRO was not aggressive enough in principle-enforcement. *See* U.S. SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET (1996) [hereinafter NASD REPORT], *available at* http://www.sec.gov/litigation/investreport/nd21a-report.txt.

A 1994 academic study drew the SEC's attention to a pricing convention where NASDAQ stocks were priced in higher one-fourth increments rather than narrower one-eighth increments. *See* William G. Christie & Paul H. Schultz, *Why Do NASDAQ Market Makers Avoid Odd-Eighth Quotes?*, 49 J. FIN. 1813 (1994). A SEC investigation found that this pricing convention was part of a collusive effort by market makers to restrict price competition in the NASDAQ market and maintain higher bid-ask spreads, resulting in higher profits for themselves. NASD REPORT, *supra*, at 13.

The SEC found that "the NASD was aware of facts and circumstances evidencing the pricing convention, actions undertaken by market makers to enforce it, and the rigidity of NASDAQ spreads" but took little action to investigate the problem. *Id*. at 35. The NASD's reaction was explained because it "viewed the pricing convention and, to a great extent, spreads, as commercial issues pertaining to its competitive standing with the New York Stock Exchange, instead of significant regulatory problems." *Id*. at 36. Large NASDAQ market makers had undue influence on the NASD. *Id*. at 46 ("During the period covered by this investigation, NASDAQ market makers in certain instances unduly influenced the NASD's regulatory process in their favor."). Rather than pursuing a significant case, the NASD focused on enforcing rules against smaller firms that were competing with larger market makers through electronic orders. *Id*. at 42. In contrast, when the NASD found a violation by established market makers, the "remedy was only to impose letters of caution or a relatively small financial penalty against the offending market maker." *Id*. at 43.

124. To be fair, SROs have participated at times in major principle-enforcement efforts but usually as one of many enforcers. The precursor to FINRA, the NASD, was involved in the case against kickbacks relating to IPO allocations. *See* Susan Pulliam et al., *Coming to Terms: CSFB Agrees to Pay $100 Million to Settle Twin IPO Investigations—Probes by SEC and NASD Grew Out of Conduct During Dot-Com Frenzy—A Legacy of Wheat's Reign*, WALL ST. J., Dec. 11, 2001, at A1. A NASD rule, Rule 2330(f), which prohibits profit sharing, was used as the main basis for liability in what turned out to be a significant principle-enforcement action. *Id*.

1. SEC as Bureaucracy

The SEC is often perceived as an ineffective enforcer because it is a large bureaucracy.[125] Bureaucracies tend to be governed by rigid hierarchies that are risk averse, relying on extensive formal procedures to govern decision making.[126] Consistent with a bureaucratic structure, SEC enforcement has been governed by an extensive review process. Until recently, the decision to issue a formal subpoena to open an investigation had to be approved by the Commissioners of the SEC.[127] Moreover, after an investigation, potential targets of an enforcement action may receive a Wells Notice informing them of the possibility of an enforcement action and given the chance to prepare a Wells Submission arguing that charges are unwarranted.[128] Upon the completion of an investigation by SEC enforcement staff, the Commissioners must approve any decision by the staff to bring an enforcement action[129] after presumably spending significant time reviewing materials to understand the case.[130]

---

125. *See, e.g.*, Mark Maremont & Deborah Solomon, *Missed Chances: Behind SEC's Failings: Caution, Tight Budget, '90s Exuberance*, WALL ST. J., Dec. 24, 2003, at A1 (describing SEC as "timid, poorly managed bureaucracy").

126. *See, e.g.*, Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 WASH. & LEE L. REV. 527, 530 (1990) (noting that bureaucracy explains SEC's "risk aversion in the face of bounded rationality."); *see also* Richard B. Stewart & Cass R. Sunstein, *Public Programs and Private Rights*, 95 HARV. L. REV. 1193, 1298 (1992) (noting that public agencies suffer from diseconomies of scale in enforcement); John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter Is Not Working*, 42 MD. L. REV. 215, 226 (1983) (noting that "public enforcer . . . is confined within a bureaucratic setting.").

127. *See, e.g.*, William R. McLucas et al., *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 TEMP. L. REV. 53, 57 (1997) ("[T]he need to obtain documents from entities that require a subpoena, such as banks and telephone companies, often necessitates a request by the staff for Commission authorization for a formal investigation."). Recognizing this problem, the SEC Commissioners delegated the power to issue a subpoena to the Director of Enforcement, who in turn delegated the power to various mid-level managers. *See* Kara Scannell, *"Urgency" Drives SEC Crackdown—New Leadership Accelerates Investigations and Levies Millions in Penalties*, WALL ST. J., Aug. 11, 2009, at C1. Of course, even prior to this reform, at an initial stage, enforcement matters could proceed through informal requests for documents.

128. *See* U.S. SEC. & EXCH. COMM'N DIV. OF ENFORCEMENT, ENFORCEMENT MANUAL 27–34 (2010). The opportunity to submit a Wells Submission is not a formal right. *See, e.g.*, Joshua A. Naftalis, *"Wells Submissions" to the SEC as Offers of Settlement Under Federal Rule of Evidence 408 and Their Protection from Third-Party Discovery*, 102 COLUM. L. REV. 1912, 1918–20 (2002) (describing establishment of the Wells Procedure).

129. *See* U.S. SEC. & EXCH. COMM'N DIV. OF ENFORCEMENT, *supra* note 128, at 34–35; *see also* McLucas et al., *supra* note 127, at 111.

The SEC has five Commissioners who are appointed by the President, one of whom is designated as Chairman. *See* Securities Exchange Act of 1934 § 4, 15 U.S.C. § 78d (2011). Only three of the five Commissioners can belong to the same political party. *See id*.

130. The SEC has often been criticized for being dominated by lawyers. Jonathan Macey argues that the lawyer-dominated culture of the SEC is a factor in the slowness of the SEC's enforcement process. *See* Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 640 (2010) ("[T]he glacial speed at which the SEC operates is largely attributable to the Commission's lawyer-dominated culture."). However, enforcers that have acted more quickly and aggressively than the SEC—state attorneys general, federal

A 2009 report by the U.S. Government Accountability Office noted that SEC "[e]nforcement staff said a burdensome system for internal case review has slowed cases and created a risk-averse culture."[131] As an enforcement case goes through each step of the SEC's vetting process, supervisors must take time to understand the case and will have opportunities to raise objections.[132] In the interim, there is often staff turnover, causing additional delay as new staff become acquainted with the case.[133] The time it takes to assess a complex case may decrease the momentum of the case, leaving a nominal settlement as the most attractive option. Excessive delay reduces the initiative of the staff and impact of the enforcement case that is ultimately brought.[134] The frustrations of dealing with a bureaucracy make it difficult to attract and retain elite attorneys who are best able to handle innovative principle-enforcement actions.[135]

It also has often been said that the SEC has a tendency to be risk averse because it is judged partly based on the number of enforcement cases it brings.[136] Given its relatively large size and jurisdiction, the SEC is expected to produce a certain amount of enforcement output. It is easier for the SEC to generate a high volume of cases by bringing rule-enforcement cases.[137] While a

---

prosecutors, and class action attorneys—are also lawyer-dominated institutions.

131. GAO REPORT, *supra* note 1, preface. Enforcement attorneys reported that they spent "a third to 40 percent of their time on the internal review process, thus making it harder to meet the division's emphasis on bringing cases on a timely basis." *Id*. at 28.

132. *See, e.g*., Thad Davis, *A New Model of Securities Law Enforcement*, 32 CUMB. L. REV. 69, 1010 (2001) (noting that "the General Counsel's Office at the SEC occupies the uniquely uncomfortable position of spoiler"); *cf*. Michael Selmi, *Public vs*. *Private Enforcement of Civil Rights: The Case of Housing and Employment*, 45 UCLA L. REV. 1401, 1444 (1998) ("A government attorney who seeks to build an affirmative action case, for example, will likely encounter numerous bureaucratic roadblocks, particularly from career attorneys who have seen administration policies change and who are reluctant to take on cases that may later become controversial.").

133. *See, e.g*., Jonathan G. Katz, *Reviewing the SEC, Reinvigorating the SEC*, 71 U. PITT. L. REV. 489, 498 (2010) (describing delay caused by enforcement staff turnover); Donald C. Langevoort, *Seeking Sunlight in* Santa Fe*'s Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449, 476 (2001) (noting "SEC's lack of enforcement resources" because of high turnover). The criticism of SEC delay is long standing. *See, e.g*., Theodore A. Levine, *Recent Developments in SEC Enforcement*, 61 N.C. L. REV. 463, 470 (1983) (noting comment from panel participant that SEC often investigates two to three years before bringing suit).

134. A report by the SEC's Inspector General collected complaints by staff relating to the SEC bureaucracy. *See* U.S. SEC. & EXCH. COMM'N OFFICE OF THE INSPECTOR GEN., NO. 467, PROGRAM IMPROVEMENTS NEEDED WITHIN THE SEC'S DIVISION OF ENFORCEMENT 20–21 (2009), *available at* http://www.sec-oig.gov/Reports/AuditsInspections/2009/467.pdf.

135. *See, e.g*., Choi & Pritchard, *supra* note 8, at 37 (observing that "[i]ndividual effort will be further reduced if the decisionmaker only has authority to make recommendations, rather than making the ultimate decision"); John P. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. COLO. L. REV. 57, 127 (2005) (describing the SEC's difficulty in recruiting elite lawyers).

136. *See, e.g*., Nocera, *supra* note 3.

137. For example, 16 percent of the SEC's enforcement cases brought in 2008 related to delinquent filings, a relatively simple rule violation. *See* GAO REPORT, *supra* note 1, at 23; *see also* Richard A. Posner, *The Behavior of Administrative Agencies*, 1 J. LEGAL STUD. 305, 311–12 (1972) (concluding that a rational administrative agency has an incentive to focus on smaller cases); Donald C. Langevoort, *The SEC and the Madoff Scandal: Three Narratives in Search of a Story* 8

significant principle-enforcement action might create a significant amount of deterrence, the effects of the action may be unclear.[138] Given the risk and time involved in enforcing principles, it may be rational for the SEC to focus on rule-enforcement cases that are straightforward and likely to settle quickly.[139]

It is important to acknowledge that the bureaucratic structure of the SEC is not just a negative. In fact, many of its aspects are necessary given the SEC's mission. The SEC is large because of its responsibility for regulating national markets. The SEC's size and resources allow it to assemble an unparalleled group of experts in all aspects of securities regulation. The layers of review help ensure a uniform enforcement product that reflects the SEC's expertise. Some scholars have noted that the review process can reduce cognitive biases that might affect SEC staff.[140]

At the same time, this structure limits the ability of the SEC to act quickly and decisively, perhaps resulting in a tendency at times to focus on rule-enforcement rather than principle-enforcement. Because of their simplicity, rule-enforcement cases are more likely to survive the many layers of review. Even with delays, rule-enforcement cases are not difficult to pass on to other staff if the original attorneys leave. Given its structure and mission, the SEC may rationally choose at times to focus on rule-enforcement over principle-enforcement.

2. SEC as an Expert

Apart from its size and bureaucracy, the SEC plays an administrative role that can make it difficult to take aggressive action based on principles reflecting

---

(Georgetown Law & Econ., Research Paper No. 1475433, 2009), *available at* http://ssrn.com/abstract=1475433 (noting incentives of SEC staff to work on small cases that settle easily). A similar dynamic has been documented in the antitrust enforcement area. *See, e.g.*, Robert A. Rogowsky, *The Pyrrhic Victories of Section 7: A Political Economy Approach*, *in* PUBLIC CHOICE AND REGULATION 220, 224–27 (Robert J. Mackay et al. eds., 1987) (observing that antitrust enforcers have incentives to avoid large cases that take up too many resources).

138. On the other hand, the influence of numerical measures of enforcement may also encourage the SEC to pursue cases that will result in numerically significant settlements. *See, e.g.*, Macey, *supra* note 130, at 646 ("The focus is on the number of cases brought by the Division, and, to a lesser extent, on the size of the fines collected by the SEC."). In addition to the number of cases it brings, the SEC also has a tendency to trumpet the amount of fines that it collects. The desire to generate significant penalties may counteract the tendency to focus exclusively on rule-enforcement.

139. As a former SEC attorney describes:

> When an agency uses faulty measures to evaluate its staff, it rewards the wrong people for the wrong actions. Nowhere is this more obvious than in the Division of Enforcement, where the benchmark for decades has been the total number of actions brought in a year, regardless of the relative importance or timeliness of the action and regardless of the result achieved. Simply put, a staff attorney who brings five separate actions for insider trading in the same stock receives credit for five 'stats.' Conversely, an attorney who brings one insider trading action involving far more trading is credited with one stat.

Katz, *supra* note 133, at 506.

140. *See, e.g.*, Choi & Pritchard, *supra* note 8, at 36 ("The process by which commissioners approve staff proposals suggests another means by which organizations can reduce cognitive bias: hierarchical review.").

contested values. The SEC is an independent agency that is expected to remain nonpartisan. As an expert regulator, it is expected to exude an aura of competence and professionalism. In addition to its enforcement duties, the SEC regulates markets whose health is vital to the nation's economy. Any benefits of enforcement must be weighed against the costs of enforcement on the industry.[141] In order to fulfill its mission, the SEC's regulatory approach must be balanced and rooted in expertise. As a result, it can be difficult for the SEC to take significant enforcement risks that raise controversial value judgments.[142]

As noted earlier, proponents of public-choice theory contend that the SEC is a victim of agency capture.[143] The SEC is pressured to respond to the influence of large firms with political influence.[144] SEC enforcement staff may hope to make connections leading to future private sector employment and may not want to alienate powerful industry members.[145] These tendencies could influence the SEC to protect larger firms from competition by mostly bringing enforcement actions against smaller upstart firms that are less sophisticated and may not have the resources to implement sufficient compliance systems.

While it is undeniable that the SEC is subject to political pressure,[146] public-choice theory tells only part of the story. The SEC is an independent agency with a strong culture that allows it to somewhat resist political pressures.[147] It is difficult to argue that an enforcement attorney can make a

141. In the antitrust context, the tension between enforcement and economic policy was reflected in the differing views of lawyers and economists that Robert Katzmann observed at the Federal Trade Commission. *See* ROBERT A. KATZMANN, REGULATORY BUREAUCRACY: THE FEDERAL TRADE COMMISSION AND ANTITRUST POLICY 42–44 (1980).

142. This tendency to avoid controversial political cases is not limited to the SEC. Michael Selmi argues, in the context of civil rights enforcement, that "[t]he federal government, with its broad resources, pursues small, politically inoffensive, and easy cases, leaving the private bar to tackle the difficult and important discrimination claims." Selmi, *supra* note 132, at 1404.

143. *See, e.g.*, Susan M. Phillips & J. Richard Zecher, THE SEC AND THE PUBLIC INTEREST (1981) (describing SEC as mediating between various interest groups); Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994) (arguing that SEC has the characteristics of a captured administrative agency).

144. Political influence, however, does not necessarily mean there is capture. For an account that acknowledges that the SEC is responsive to political influence but skeptical of the capture theory, see Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591 (2006).

145. Two commentators on the financial industry assert that "[i]f you work for the enforcement division of the S.E.C. you probably know in the back of your mind, and in the front too, that if you maintain good relations with Wall Street you might soon be paid huge sums of money to be employed by it." Michael Lewis & David Einhorn, *The End of the Financial World as We Know It*, N.Y. TIMES, Jan. 4, 2009, at 9.

146. *See, e.g.*, Macey, *supra* note 143, at 646–47 (describing how the SEC responds to political pressure).

147. *See, e.g.*, Robert B. Thompson, *The SEC After the Financial Meltdown: Social Control Over Finance?*, 71 U. PITT. L. REV. 567, 572–76 (2010) (describing the procedures and organization of the SEC and the agency's impartiality).

reputation for himself without enforcing the securities laws aggressively.[148] Indeed, the SEC has a proud history of bringing path-breaking enforcement actions. Moreover, the public closely scrutinizes the SEC, so weak enforcement efforts can leave it vulnerable to criticism.[149]

While certainly the SEC must act within the constraint of a powerful industry, its slowness to act at times is more likely the result of cautious expertise rather than corrupt catering to the industry.[150] Because of its role as an expert administrative regulator, the SEC must balance costs and benefits for its decisions to have legitimacy.[151] Questions of market stability can conflict with the need for aggressive enforcement,[152] and the SEC must navigate both concerns. As a result, the SEC has reason to refrain from innovative principle-enforcement, focusing instead on less controversial rule-enforcement.

3. Major Periods of SEC Enforcement

As a result of the constraints of its bureaucracy and role of an expert regulator, SEC enforcement tends to be characterized by periods of significant principle-enforcement followed by periods where enforcement efforts are stifled by its institutional limitations. This Subsection provides a brief sketch of some of the major periods of SEC enforcement.

In its early years, the SEC established its enforcement presence through principle-enforcement in two major areas: insider trading and corrupt foreign

148. *See, e.g.*, Langevoort, *supra* note 144, at 1621. It would be a mistake to consider the SEC staff to be an undifferentiated bureaucracy. *See generally* Leonard Reissman, *A Study of Role Conceptions in Bureaucracy*, 27 SOC. FORCES 305, 308–10 (1949) (distinguishing bureaucrats who seek recognition from external professional groups and bureaucrats who are immersed within the bureaucratic structure).

149. *See* articles cited *supra* note 3.

150. John Coates notes that the SEC serves as a moderating influence on political overreaction to economic scandal. *See* Coates, *supra* note 8, at 557; *see also* ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION 119–20 (1992) (describing SEC's expertise as mechanism by which it resists politicization). *But see* Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549, 579 (2002) ("The problem with administrative agencies is the problem that all experts face: They are apt to be overconfident in their decisionmaking.").

151. Critics of aggressive securities enforcement have invoked the ideal of an expert, restrained regulator. *See, e.g.*, U.S. CHAMBER OF COMMERCE, *supra* note 5, at 16–17 ("[W]here an agency is charged with setting sound regulatory policy to govern a system as unique, complex, and fundamentally important to the U.S. economy as the national securities markets, that agency must, it would seem, maintain the highest level of objectivity and informed decision-making possible in pursuing enforcement actions.").

152. *See, e.g.*, Chester S. Spatt, *Regulatory Conflict: Market Integrity vs. Financial Stability*, 71 U. PITT. L. REV. 625, 632 (2010) (noting tension between market stability and enforcement interests in a recent enforcement case against Bank of America for misleading disclosures relating to acquisition of Merrill Lynch); *see also* Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1144 (2003) (noting that the SEC's mission of "promot[ing] the viability and attractiveness of broad individual participation in the stock markets . . . is a strong check on too much drift in the progressive direction.").

payments.[153] The prohibition of insider trading required expanding Rule 10b-5's fraud prohibition to cover trading on markets that did not fit within the common law definition of fraud. The first official pronouncement that Rule 10b-5 prohibited insider trading was an SEC order in *Cady, Roberts & Co*.[154] The SEC pursued and obtained judicial ratification of this interpretation of Rule 10b-5 in *SEC v. Texas Gulf Sulphur Co*.[155] Throughout the years, the SEC has consistently pushed the boundaries of insider trading law.[156]

In the 1970s, the newly formed SEC Division of Enforcement pursued questionable payments to foreign officials by public corporations that were not reflected in public disclosures.[157] Though no SEC rule directly prohibited such payments, the SEC argued that the payments violated a principle of full and accurate disclosure.[158] The SEC's efforts were controversial in that many of the payments were not obviously material, at least in that they were not substantial enough to significantly affect financial results.[159] Moreover, such payments were arguably consistent with industry practice,[160] requiring the SEC to use a principle to challenge industry values.[161]

---

153. *See, e.g.*, William R. McLucas et al., *Common Sense, Flexibility, and Enforcement of the Federal Securities Laws*, 51 BUS. LAW. 1222 (1996) (noting that "the SEC has tried to address new issues that have emerged in our rapidly changing capital market system without the benefit, or the hinderance [sic], of precise proscriptions.").

154. *See In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

155. Sec. & Exch. Comm'n v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc).

156. *See, e.g.*, Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315 (2009) (describing recent efforts by the SEC to expand insider trading liability).

157. *See* U.S. SEC. & EXCH. COMM'N, 94TH CONG., REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES 2–13 (Comm. Print 1976); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 539–43 (2003).

158. *See, e.g.*, Edward D. Herlihy & Theodore A. Levine, *Corporate Crisis: The Overseas Payment Problem*, 8 LAW & POL'Y INT'L BUS. 547, 569–77 (1976); Note, *Disclosure of Payments to Foreign Governments Under the Securities Acts*, 89 HARV. L. REV. 1848, 1850–51 (1976).

159. *See, e.g.*, John C. Coffee, Jr. *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1258–59 (1977) (noting that SEC's materiality arguments with respect to foreign payments were problematic).

160. REPORT ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, *supra* note 157, at 44 ("[A] survey taken by the Opinion Research Corporation in July of 1975 indicated that nearly half of America's business executives saw nothing wrong with paying foreign officials in order to attract or retain contracts.").

161. The SEC's power to sanction was limited in its early years, so it tended to focus on prospective relief. *See, e.g.*, Katz, *supra* note 133, at 509; Levine, *supra* note 133, at 469 ("The injunctive authority is the primary civil weapon when the SEC brings an action . . . ."); Stanley Sporkin, *SEC Enforcement and the Corporate Board Room*, 61 N.C. L. REV. 455, 459 (1983) (noting SEC's use of consent decrees). An SEC strategy was to follow enforcement with rulemaking meant to address issues that had been uncovered through the enforcement process. *See, e.g.*, Sporkin, *supra* at 460. Indeed, the SEC's foreign payments investigation spurred the passage of the Foreign Corrupt Practices Act, which prohibited such payments and imposed new books and records requirements on public corporations. Foreign Corrupt Practices Act of 1977, 91 Stat. 1496, 15 U.S.C. §§ 78dd-1 to -3 (2006).

These early efforts of principle-enforcement resulted in some backlash as prominent critics highlighted the SEC's tendency to develop principles through "regulation by enforcement."[162] Critics insisted that the SEC should rely more on rulemaking rather than enforcement actions in creating law.[163] They argued that principle-enforcement did not give the industry enough notice as to what conduct was prohibited.[164] Perhaps wary of this critique, as will be discussed below, the SEC arguably became more cautious in enforcing principles. After all, rather than bringing an innovative case that would create controversy, the SEC can simply pass a rule prohibiting such conduct in the future.[165]

Despite its innovative enforcement efforts, for much of its history the SEC has been limited in its ability to pursue significant sanctions through principle-enforcement. For many years, the SEC could only seek injunctive relief and minor fines, leading one commentator to describe its staff as "The Wrist Slappers."[166] Thus, even when it enforced broadly worded statutes, SEC enforcement might have looked more like uncontroversial rule-enforcement than controversial principle-enforcement.

---

162. *See, e.g.*, ROBERTA KARMEL, REGULATION BY PROSECUTION 95 (1982) (noting the SEC's "predilection for formulating regulatory policy through the prosecution of enforcement cases"); Pitt & Shapiro, *supra* note 97, at 156 ("The SEC *has*, at times, resorted to *ad hoc* enforcement of the federal securities laws in particular contexts, in the absence of meaningful advance guidance (or warning) to those subject to the agency's jurisdiction, in large measure because of the agency's institutional fear that any specific regulations it might promulgate could prove underinclusive or susceptible of easy evasion."); *see also* Coffee, *supra* note 159, at 1252 (describing questions about SEC's moralistic use of enforcement rather than rulemaking in response to improper payments controversy); Langevoort, *supra* note 126, at 530–31 (noting SEC's "disinclination to adopt or endorse bright-line rules").

163. *See* Pitt & Shapiro, *supra* note 97, at 167 (arguing for clearer definition of law through rulemaking).

164. *See id.*

165. An example of this dynamic is the SEC's response in the 1990s to the problem of selective disclosure of material information by companies. When it became apparent that companies were disclosing inside information to select analysts, the SEC might have brought a principle-enforcement case to make it clear that such conduct was insider trading. But such a course of conduct was risky given the uncertain state of the law and prior criticisms of the SEC's efforts to expand insider trading doctrine through litigation. *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, 65 Fed. Reg. at 51,718 (Aug. 24, 2000). Instead, the SEC passed a rule, Regulation FD, which prohibited selective disclosure. *See* 17 C.F.R. § 243.100–.103 (2007).

166. *See* MICHAEL C. JENSEN, THE FINANCIERS 283–307 (1976). As the commentator described:

> SEC action is considered an irritant by most offenders. It is the prospect of a private law suit that really chills them. SEC actions have traditionally served as devices to intimidate violators. Penalties are minimal—a thirty-day suspension from securities activity; a fine of a few thousand dollars. Usually there is one quick blast of bad publicity when the charge is filed by the SEC, followed by a consent agreement the same day by the company or firm being charged. Even the consent is hedged. A defendant is allowed to agree to the sanction without admitting that he is guilty of the charges.

Id. at 285–86.

After receiving the general power to seek civil fines for securities law violations in 1990,[167] for ten years the SEC used the power sporadically against larger companies.[168] One study found that from 1997 to 2002, SEC enforcement actions targeted companies with smaller market capitalizations than companies targeted by class actions.[169] In targeting relatively small companies, the SEC may have been focusing on targets that were more likely to commit obvious rule violations and less able to resist enforcement.

The SEC has long been notorious for settling cases for relatively low amounts either very quickly,[170] or after many years of inconclusive investigation.[171] Such an approach reflects a low-risk approach to principle-enforcement that resembles rule-enforcement. A defendant is more likely to agree to a settlement after the case has been pushed into obscurity by the passage of time.[172] Rather than risk lengthy litigation to establish that a target acted with culpable intent, the SEC might settle for characterizing the misconduct as a rule violation that only warrants a nominal penalty.

More recently, with the wave of financial frauds that began in the early 2000s, the SEC began targeting larger companies and imposing more significant penalties.[173] But the era of renewed principle-enforcement was one in which the SEC often played a reactive role to the principle-enforcement actions brought by the New York Attorney General.[174] After a period of

---

167. *See* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990). A few years before, the SEC was first granted the power to seek civil penalties in insider trading cases. *See* Insider Trading and Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988); Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984).

168. *See* U.S. CHAMBER OF COMMERCE, *supra* note 5, at 27 (noting imposition of two penalties of $1 million and $3.5 million from 1990 to 2002). A notable exception to the SEC's lack of willingness to seek penalties against public companies was its case against Salomon Brothers. *See* Sec. & Exch. Comm'n v. Salomon Brothers Inc., SEC Litigation Release No. 13246 (S.D.N.Y. May 20, 1992) (announcing $190 million civil penalty against Salomon Brothers).

169. Cox et al., *supra* note 51, at 776 (stating that the SEC "almost always targets companies with a market capitalization less than $200 million largely because these smaller capitalized companies frequently lack audit committees, or if they do have such committees, they do not appropriately staff them") (citing MARK S. BEASLEY ET AL., FRAUDULENT FINANCIAL REPORTING: 1987–1997, AN ANALYSIS OF U.S. PUBLIC COMPANIES (1999)).

170. A prominent example was the quick settlement of proxy fraud charges against Bank of America for thirty-three million dollars in 2009 that the district court initially refused to approve. *See* Sec. & Exch. Comm'n v. Bank of Am. Corp., 653 F.Supp.2d 507 (2009). The case was later settled for $150 million. *See* Sec. & Exch. Comm'n v. Bank of Am. Corp., No. 09-Civ.-6829, 2010 WL 624581 (S.D.N.Y. Feb. 22, 2010).

171. *See, e.g.*, Katz, *supra* note 133, at 498 (noting how older investigations were closed with little or no action).

172. A similar dynamic has been described with respect to antitrust enforcement. *See, e.g.*, Rogowsky, *supra* note 137, at 232 (noting tendency of government to settle cases with consent decrees to achieve a "victory").

173. *See* James D. Cox & Randall S. Thomas, *Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?*, 80 NOTRE DAME L. REV. 893, 906–07 (2005).

174. *See, e.g.*, Eric Zitzewitz, *An Eliot Effect? Prosecutorial Discretion in Mutual Fund Settlement Negotiations, 2003-7* (Working Paper Series, Apr. 21, 2008), *available at*

increased enforcement, the SEC found itself criticized for its imposition of significant penalties and responded by seeking to limit the situations where such penalties would be sought.[175] The criticism resulted in policies that "discouraged pursuit of more complicated cases, those based on novel legal reasoning, or those with industrywide implications, in favor of those seen as more routine or more likely to win Commission approval."[176] In other words, the SEC shifted from principle-enforcement to rule-enforcement. The back and forth in enforcement policy suggests that the SEC can have trouble sustaining adequate principle-enforcement efforts.[177]

A regulatory enforcer such as the SEC is willing to enforce principles, but will often find itself unable to effectively do so because of its institutional limitations.

C. Public-Values Enforcers

Some of the most controversial principle-enforcement occurs when aggressive enforcers pointing to public values challenge industry standards. Federal prosecutors and state attorneys general have, at times, injected themselves into securities enforcement, relying on their authority as representatives of the people. Such public-values enforcers are not as subject to capture as the SEC and are not subject to the same bureaucracy, though they are more susceptible to political influence.

1. Federal Prosecutors

Federal prosecutors have played a significant role in securities enforcement. In the 1980s, federal prosecutors brought major insider trading cases against prominent defendants.[178] In the 2000s, federal prosecutors won convictions of individuals in securities fraud prosecutions involving significant public companies such as Enron,[179] WorldCom,[180] and Adelphia.[181] Some of the riskiest, most significant, principle-enforcement has occurred through federal prosecutions.

---

http://www.ssrn.com/abstract=1091035 (finding that mutual fund settlements involving New York Attorney General were higher than settlements brought solely by the SEC).

175. *See* Christopher Cox, Chairman, Sec. & Exch. Comm'n, Address to the Mutual Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007), *available at* http://www.sec.gov/news/speech/2007/spch041207cc.htm.

176. GAO REPORT, *supra* note 1, at 42.

177. *See generally* Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785, 803–15 (2009) (describing failures in SEC leadership in period prior to financial crisis).

178. *See, e.g.*, United States v. Milken, 759 F. Supp. 109 (S.D.N.Y. 1990); United States v. Boesky, 674 F. Supp. 1128 (S.D.N.Y. 1987).

179. *See* John R. Emshwiller et al., *Symbol of an Era: Lay, Skilling Are Convicted of Fraud*, WALL ST. J., May 26, 2006, at A1.

180. *See* United States v. Ebbers, 458 F.3d 110, 112 (2d Cir. 2006).

181. *See* Peter Grant & Christine Nuzem, *Adelphia Founder and One Son Are Found Guilty*, WALL ST. J., July 9, 2004, at A1.

Federal prosecutors have the ability to pursue principle-enforcement because many criminal statutes are broadly worded.[182] Moreover, federal prosecutors are limited in their ability to engage in rule-enforcement in the context of the securities laws. Federal prosecutors can only target the most egregious conduct that evidences criminal intent. An accidental violation of a regulation will not suffice—a federal prosecution relating to the securities laws will always involve fact-intensive inquiry into the defendant's motive.

Because they do not have the SEC's rulemaking power over the securities markets, federal prosecutors do not have the option of addressing misconduct by simply passing a rule. Federal prosecutors are not as invested in the regulatory framework and are less subject to the argument that the proper remedy to misconduct is to simply pass a rule. Federal prosecutors, of course, may feel the need to defer to the SEC's expertise, but such deference is unlikely when there is clear evidence of egregious conduct. Indeed, the SEC often refers cases to federal prosecutors, recognizing their ability to seek greater sanctions and their skill at trying cases.[183]

Federal prosecutors are less subject to capture than the SEC. Federal prosecutors do not have the burdens of constant pressure from the securities industry and nationwide responsibility for securities regulation. They do not have the burden of encouraging capital formation and watching over the soundness of the industry. Federal prosecutors are more diversified than the SEC in that their success does not hinge solely upon whether they are perceived as even-handed securities regulation experts. Moreover, federal prosecutors have a strong culture of independence from political influence.[184] Though some federal prosecutors have political ambitions,[185] for the most part federal prosecutors are diligent about only proceeding when they are certain that they have a case on which they can prevail at trial. Of course, that is not to say that federal prosecutors do not overreach, as evidenced by a number of high-profile

182. The federal wire and mail fraud criminal statutes are broadly worded. *See* 18 U.S.C. §§ 1341, 1343 (2011). However, the Supreme Court has narrowed the reach of one criminal statute used in a securities fraud case, section 1346, which prohibits the deprivation of "honest services," to cases involving bribes or kickbacks. *See* United States v. Skilling, 130 S. Ct. 2896 (2010).

183. Indeed, the federal securities laws envision such referrals. *See* Securities Act of 1933 § 20(b), 15 U.S.C. § 77t(b) (2011); Securities Exchange Act of 1934 § 21(d), 15 U.S.C. § 78u(d) (2011).

184. *See, e.g.*, Baer, *supra* note 110, at 982 ("Federal prosecutors are not as likely to fall prey to capture as their counterparts in administrative agencies because, unlike the policymakers at the SEC and similar agencies, prosecutors are judged primarily by their criminal convictions."). *But see* Darryl K. Brown, *Cost-Benefit Analysis in Criminal Law*, 92 CALIF. L. REV. 323, 360 (2004) (noting improper influences on prosecutorial decision making).

185. *See, e.g.*, Kahan, *supra* note 16, at 486 ("U.S. Attorneys are extraordinarily ambitious and frequently enter electoral politics after leaving office."). *But see* Daniel C. Richman, *Federal Criminal Law, Congressional Delegation, and Enforcement Discretion*, 46 UCLA L. REV. 757, 777 (1999) (noting reputation of U.S. Attorneys for objectivity).

reversals of criminal convictions in obstruction of justice cases arising out of securities fraud investigations.[186]

Because the units that concentrate on securities enforcement are small, federal prosecutors can be more nimble than the SEC.[187] A smaller group may capture more of the benefits of a successful enforcement case and thus may be more willing to investigate and develop a principle-enforcement action. A smaller organization may be less hierarchical, giving staff attorneys quick access to decision makers and making the office more attractive to attorneys seeking interesting cases. Indeed, federal prosecutors are known for seeking to work on cases involving elite defendants who might put on a more vigorous defense because of the challenge and career value of complex cases.[188] If the group has the reputation of bringing interesting and important cases, [189] it can recruit elite attorneys who are best able to pursue principle-enforcement.

Drawing upon the power of the criminal law, federal prosecutors are likely to focus on enforcing public values rather than deferring to industry standards. In particular, criminal statutes often express public values in their various prohibitions.[190] Because criminal statutes tend to be expansively worded, they give federal prosecutors significant discretion in targeting egregious misconduct.[191] Thus, federal prosecutors often see themselves as lawyers representing the people in enforcing the law.

Though federal prosecutors may be more willing to take on the risk of principle-enforcement than SROs or the SEC, the high standard for criminal liability significantly checks the ability of federal prosecutors to enforce principles. Because the sanction for criminal misconduct can be so high, federal prosecutors are limited in their ability to exercise their powers without the clearest evidence of wrongdoing. Securities law cases tend to involve complex

186. *See, e.g.*, Arthur Andersen LLP v. United States, 544 U.S. 696 (2005) (reversing conviction of accounting firm Arthur Andersen LLP); United States v. Quattrone, 441 F.3d 153 (2d Cir. 2006) (reversing conviction of investment banker Frank Quattrone).

187. *See, e.g.*, Davis, *supra* note 132, at 123 ("[A] line Assistant United States Attorney prosecuting a given case faces none of the bureaucratic constraints that the Enforcement Division staff face at the Commission.").

188. One study finds evidence that federal prosecutors maximize their capital by targeting "the wealthier, more prestigious set of criminals, who are more likely to have private lawyers." Edward L. Glaeser et al., *What Do Prosecutors Maximize? An Analysis of the Federalization of Drug Crimes*, 2 AM. L. & ECON. REV. 259, 273 (2000).

189. The elite U.S. Attorney's Office for the Southern District of New York has a reputation for expertise in prosecuting securities fraud cases. *See, e.g.*, Pritchard, *supra* note 34, at 1096–97 ("The Justice Department has many lawyers and investigators who are proficient at prosecuting securities fraud (e.g., the fraud unit of the U.S. Attorney's office in the Southern District of New York).").

190. *See, e.g.*, Sanford H. Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423, 437 (1963) ("The central distinguishing aspect of the criminal sanction appears to be the stigmatization of the morally culpable.").

191. A problem, though, with utilizing the criminal law with respect to regulatory issues is that it might supplant more appropriate civil remedies. *See, e.g.*, Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361 (2008).

facts, making it difficult to build a case that can be explained to a jury.[192] Federal prosecutors thus can only pursue a limited number of principle-enforcement cases.

Of course, the severity of a criminal sanction leads to high incentives for defendants to plea bargain, especially corporate defendants.[193] Over-aggressive federal prosecutors could use this leverage to unfairly extort plea bargains from risk-averse defendants. On the other hand, individual criminal defendants have an incentive to contest criminal cases through trial because even a settlement may require serving prison time. Securities fraud often involves wealthy individuals with the resources to fight a conviction.[194]

Despite the high criminal standard, federal prosecutors have been willing to take on difficult securities enforcement cases to enforce public values, even when there is a substantial risk of loss at trial. In taking on such risk, federal prosecutors have shown themselves to be principle-enforcers.

2. State Attorneys General[195]

At various times, state attorneys general have brought significant securities enforcement cases.[196] The New York Attorney General's principle-enforcement actions of the 2000s against research analysts and the mutual fund industry are well known[197] and had precedent in much earlier principle-enforcement efforts. As Henry Manne wrote in 1966: "The attorney general of New York, operating under the simplest and shortest securities laws in the country, regularly vies with the SEC, operating under the most complex and detailed system, for the prosecution of fraudulent stock manipulators."[198]

---

192. *See, e.g.*, Jonathan D. Glater & Ken Belson, *In White-Collar Crimes, Few Smoking Guns*, N.Y. TIMES, Mar. 12, 2005, at C1 ("The federal securities laws, with their complex requirements, only make the government's task more difficult and create opportunities for smart, high-priced defense lawyers to create reasonable doubt in jurors' minds.").

193. Prosecutors have used their leverage in corporate fraud prosecutions to implement controversial remedies such as structural reform. *See generally* PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT (Andrew S. Barkow & Rachel E. Barkow eds., 2011) (collecting essays discussing issues raised by criminal prosecutions of corporations).

194. *See, e.g.*, William J. Stuntz, *The Uneasy Relationship Between Criminal Procedure and Criminal Justice*, 107 YALE L.J. 1, 29–30 (1997) (observing that white collar crimes such as securities fraud often involve wealthier defendants).

195. In the interests of full disclosure, from 2004–2007, I served as an assistant attorney general in the Investor Protection Bureau of the New York Attorney General's Office.

196. In particular, states have focused on efforts that protect retail investors. *See* Fisch, *supra* note 177, at 798.

197. For a description of these cases as examples of principle-enforcement, see Park, *The Competing Paradigms of Securities Regulation*, *supra* note 82, at 651–62.

198. HENRY MANNE, INSIDER TRADING AND THE STOCK MARKET 148 (1966). It is important to acknowledge that states other than New York have also been involved in securities enforcement. *See, e.g.*, Michael Powell & Mary Williams Walsh, *A.I.G. to Pay $725 Million in Ohio Case*, N.Y. TIMES, July 17, 2010, at B1.

In many ways, state attorneys general are similar to federal prosecutors in their approach to securities enforcement. Like federal prosecutors, state attorneys general do not have rulemaking power and largely rely on broadly worded anti-fraud statutes such as New York's Martin Act.[199] Like federal prosecutors, state attorneys general are not primarily in the business of securities regulation and are less subject to capture by the industry.[200] Like the securities divisions of federal prosecutors, the securities enforcement units of state attorneys general tend to be relatively small and can move faster and take more risks than an enforcement group that is part of a layered bureaucracy.[201] Like federal prosecutors, state attorneys general see themselves as lawyers for the people who are seeking justice rather than experts administering a regulatory system.[202]

Perhaps the main difference between federal prosecutors and state attorneys general is that state attorneys general have the ability to enforce principles through civil suits. As a result, they have greater ability to take on principle-enforcement than federal prosecutors who are limited to bringing criminal cases. Because the sanctions are civil rather than criminal, the decreased burden of proof allows a state attorney general greater discretion to bring a case where the evidence is contestable.

Because they are often elected, state attorneys general are more subject to political influence than federal prosecutors. Principle-enforcement may be a more effective way to gain publicity than run-of-the mill rule-enforcement.[203] In times when populist sentiment is high, state attorneys general may cater to

---

199. The Martin Act, 23-A, N.Y. GEN. BUS. LAW §§ 352–353 (Consol. 2011). State rule-based regulation of securities is largely preempted by the federal scheme. *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996). In addition, private securities class actions based on state law are also preempted. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.). However, states have retained power to "investigate and bring enforcement actions." 15 U.S.C. §§ 77p(e), 78bb(f)(4) (2011).

200. *See, e.g.*, Jonathan R. Macey, *State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117, 125 (2004) ("[T]he intensity of Spitzer's efforts can in some measure be attributed to the fact that the New York Attorney General's Office enjoys more distance from, and is therefore less susceptible to capture by, the very entities it is charged with regulating.").

201. S*ee, e.g.*, John T. Scholz & Feng Hui Wei, *Regulatory Enforcement in a Federalist System*, 80 AM. POL. SCI. REV. 1249, 1258 (1986) ("State bureaucracies are small enough to be able to rely on informal, personal supervision than can federal bureaucracies, which require more formal procedures, standards, and reports to ensure uniformity of actions in geographically dispersed areas."); Monica Langley, *The Enforcer: As His Ambitions Expand, Spitzer Draws More Controversy*, WALL ST. J., Dec. 11, 2003, at A1 (noting that Attorney General Spitzer's securities fraud bureau had about fifteen attorneys).

202. In the antitrust context, it has been noted that state attorney general enforcement reflects "socio-political" norms as opposed to "technical regulatory knowledge." Crane, *supra* note 32, at 49–50.

203. *See, e.g.*, Macey, *supra* note 200, at 121 ("[S]uing (and settling cases with) securities firms is a much better strategy for [becoming governor] than suing used car dealerships in Utica, N.Y., where he soon will be shaking hands on his quest for new lodging in the Governor's mansion.").

the public by aggressively pursuing unpopular companies. The ability to bring both criminal and civil cases might lead a state attorney general to use the threat of criminal sanction to extort a civil settlement. The political enforcer will gain the political benefits of a successful action and may not bear all of the costs of principle-enforcement.[204] On the other side of the coin, a state attorney general may be too cautious in pursuing principle-enforcement cases because of political ambitions.[205] If the securities industry is influential in state politics, the state attorney general may choose not to antagonize the industry.

State attorneys general are like federal prosecutors in their willingness and ability to enforce principles. State attorneys general are more likely to take on risk than federal prosecutors because of their ability to bring civil suits, but are more susceptible to political influence than federal prosecutors.

D. Entrepreneurial Enforcers: Class Action Attorneys

Much securities enforcement, especially fraud enforcement, occurs through private class actions. Class action attorneys are entrepreneurial enforcers, willing to invest resources in pursuing innovative theories of wrongdoing.[206] Motivated by the possibility of a large contingency fee, class action attorneys can be more willing to take on the cost and controversy of litigating complex principle-enforcement actions than public enforcers. Many entrepreneurial enforcers also see themselves as enforcing public values, though the profit motive leads them at times to unfairly presume that defendants are acting with the darkest motives.

Entrepreneurial enforcers are often able to act quickly and aggressively. While some class action firms are sizeable, most class action attorneys work for small firms and generally do not have to work through a multi-layered bureaucracy to bring a case.[207] Because entrepreneurial enforcers are typically paid only if successful and do not have subpoena power that would allow them to find smoking guns before filing a case, they are almost by definition risk-preferring enforcers.

Unlike public enforcers, whose incentive to enforce may be to serve the public interest, entrepreneurial enforcers are motivated by profit. Indeed, class

---

204. *See, e.g.*, Kahan, *supra* note 16, at 487–88 ("Individual U.S. Attorneys internalize the political benefits and externalize the practical and human costs of adventurous readings of federal criminal law.").

205. *See, e.g.*, Michael Powell et al., *Cuomo's AIG Moment Is His Political Moment*, N.Y. TIMES, Mar. 21, 2009, at A11 (noting criticism of New York Attorney General Cuomo for being "too quick to settle").

206. The observation that private attorneys bring innovative cases is a common one. *See, e.g.*, Stephenson, *supra* note 16, at 112–13 (citing examples of innovative enforcement by class action attorneys).

207. *See, e.g.*, John C. Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 706–08 (1986) (observing that class action firms tend to be small).

action attorneys are notorious for racing to the courthouse in search of the next case.[208] A social benefit of the profit motive is that entrepreneurial enforcers are willing to take on the cost of developing the facts and litigating a principle-enforcement case. The entrepreneurial enforcer captures a significant portion of a higher settlement or judgment, giving him an incentive to litigate a case with merit until the other side capitulates. In contrast, a government enforcer may be satisfied with a quick settlement that results in a smaller pay-off because he does not capture monetary benefits from a higher settlement and may be judged by the number of cases he has resolved.

In certain circumstances, the willingness to litigate a case for years until a significant settlement has been reached may be essential to meaningful principle-enforcement. Admittedly, almost all class actions are settled and settlements may not convey a clear message that a principle has been violated.[209] But the amount of a settlement can send a signal about the nature of the violation. Quick, nominal, settlements tend to convey that misconduct was no more than a technical violation. A significant settlement, on the other hand, can mean that there is merit to an allegation and that a principle is likely to have been violated. The multi-billion dollar settlements class action attorneys secured in the Enron and WorldCom cases are examples of settlements that took years to achieve and signaled the merit of the underlying claim.[210] Of course, some settlements are significant partly because of factors unrelated to merit such as the potential size of damages or the desire to be rid of a case that has dragged on for years, but given the wide distribution of the size of settlements,[211] it is likely that merit is a factor in determining whether a settlement is significant.

Entrepreneurial enforcers have not only recovered significant amounts, but have brought actions that have pushed the boundaries of the law. Efforts by class action attorneys to extend class action liability under Rule 10b-5 to gatekeeper defendants have been thwarted,[212] but have also resulted in multi-

208. To address this problem, the PSLRA created a presumption that the plaintiff with the largest financial loss rather than the plaintiff that files the first case should be the lead plaintiff. *See* 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I)(bb) (2011).

209. *See, e.g.*, Richard Frankel, *The Disappearing Opt-Out Right in Punitive-Damages Class Actions*, 2011 WIS. L. REV. 563, 608–10 (noting that defendants do not concede wrongdoing in a settlement).

210. *See, e.g.*, *In re* Enron Corp. Sec. Derivative & "ERISA" Litig., No. MDL-1446, 2008 WL 4178151 (S.D. Tex. Sept. 8, 2008) (approving seven billion dollar settlement); *In re* WorldCom Sec. Litig., No. 02 Civ. 3288, 2005 WL 2319118 (S.D.N.Y. Sept. 21, 2005) (approving six billion dollar settlement).

211. *See, e.g.*, James D. Cox et al., *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 384 (2008) (documenting wide variance in securities class action settlements and contending that such variance is evidence that merits affect size of settlement).

212. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008); Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

billion dollar settlements.[213] In the WorldCom case, class action attorneys won a ruling imposing a high standard for underwriter due diligence obligations in the context of shelf registrations,[214] establishing law in an area that has rarely been litigated.

At the same time, it is important to recognize that class action attorneys are risk averse in their own way. The entrepreneurial enforcer has incentives to settle cases for too little in order to avoid receiving nothing if the case is dismissed.[215] Entrepreneurial enforcers may also cherry pick cases involving obvious payouts. For example, class action attorneys often file a private suit making similar allegations as an earlier case brought by a public enforcer such as the SEC.[216]

Though entrepreneurial enforcement can be said to express public values, a disadvantage of the profit motive is that it creates incentives to impose unreasonably high standards of conduct on defendants. The main problem is not that entrepreneurial enforcers will bring cases that are completely without merit,[217] but that an entrepreneurial enforcer will almost never give the benefit of the doubt to the defendant. Entrepreneurial enforcers have an economic incentive to assume that any evidence of fraud supports the worst possible set of facts so that a settlement can be coerced from the defendant.[218] An industry will find it difficult to operate when it can always be second-guessed by enforcers who have the motivation to scrutinize their conduct with the presumption that any mistake is an indication of fraud.

Entrepreneurial enforcers are also disadvantaged relative to government enforcers such as the SEC, federal prosecutors, and state attorneys general because they do not have the power to subpoena documents before bringing a case. As a result, there is a greater risk of error in the suits that they bring. Many cases are essentially decided at the motion to dismiss stage, when the facts have not been fully developed, and settlements that come after a motion to dismiss is denied might merely reflect an economic decision to avoid the costs

213. *See, e.g.*, *In re Enron*, 2008 WL 4178151 (approving seven billion dollar settlement fund including settlements by gatekeepers). Nonsettling defendants prevailed on appeal with the U.S. Court of Appeals for the Fifth Circuit. *See* Regents of the Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc., 482 F.3d 372 (5th Cir. 2007) (rejecting scheme liability theory as basis for class certification).

214. *In re* WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

215. *See, e.g.*, Coffee, *supra* note 126, at 230–36.

216. *See, e.g.*, *id.* at 224–26 (noting early criticism that private attorneys piggyback off of cases by public enforcers). However, one study finds that from 1997 to 2002, only 15 percent of settled private class actions had a parallel SEC enforcement action. *See* Cox et al., *supra* note 51, at 777.

217. *See, e.g.*, Charles M. Yablon, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567, 568 (2000) (arguing that "many of the securities class action claims condemned as 'nuisance suits,' frivolous claims with no chance of success, are in all likelihood 'longshots,' claims with relatively low probabilities of success (say, between ten and thirty percent) but with positive expected returns to the lawyers who bring them.").

218. *See, e.g.*, Rose, *supra* note 30, at 1330 (observing that private enforcers have incentives to coerce rather than cooperate with defendants).

of discovery.[219] With settlements, a class action may not do much to enforce a principle other than to indicate there is a possibility that there was a fraud.

The profit motive gives class action attorneys incentives to invest in resource-intensive cases but also creates incentives to take an unreasonably pessimistic view of human nature in scrutinizing industry conduct.

IV.
THE COMPETING VALUES OF SECURITIES ENFORCEMENT

As Part III should make clear, different values motivate enforcers and influence their approach to enforcing principles. The current system of multiple enforcers reflects a pluralistic approach. This Part further identifies, describes, and contrasts the values that influence securities enforcement, and discusses the potential conflict between such values.

A. Enforcement Values

There are at least three categories of values that might influence and be expressed through securities enforcement: (1) industry values; (2) regulatory values; and (3) public values. Though any categorization will be somewhat artificial, examining these values should help illustrate the different approaches to enforcing principles.

1. Industry Values

The industry can have significant influence on the regulatory scheme. An industry's knowledge of its internal practices is likely greater than that of an external regulator. Regulators will rightly defer to the industry on some issues because of the industry's expertise and it may be cost effective to delegate some regulatory functions to the industry. An industry should have incentives to enforce rules of the game that define what conduct is acceptable. An enforcement approach rooted in industry values will value both predictability and reliance on industry standards in defining the enforcement of principles.

a. Predictability

A regulatory scheme should do its best to be predictable. Firms need to be aware of what conduct is prohibited so they can structure their behavior accordingly. Most companies want to follow the law and want to avoid running afoul of regulators. Industry participants may be unwilling to take necessary risks if a regulatory system is unpredictable. Because they are often targeted as scapegoats during times of economic crisis, firms will find predictable and specific regulations that limit the discretion of ambitious regulators to be attractive.[220]

219. *See, e.g.*, Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 740–41 (1995).

220. *See, e.g.*, Coffee & Sale, *supra* note 53, at 755 (noting with respect to materiality standard,

An enforcement system can further the goal of predictability by focusing on rule-enforcement. A firm can increase the probability that its conduct falls within the rules by investing in compliance measures and paying diligent attention to the rules' specific requirements. If there are mistakes from time to time, the sanction will be relatively mild and can be seen as a cost of doing business. While a burden, compliance is part of the regimen that is inevitable for the highly regulated securities industry and should be quite tolerable if it is predictable.

Principle-enforcement, in contrast, can be viewed by the industry with distrust because of its potential unpredictability. As noted earlier, principles give less notice than rules concerning what conduct is permissible.[221] Broadly defined principles can give regulators the ability to build cases against conduct that falls in gray areas. Ambitious regulators can use principle-enforcement to pressure firms to settle for significant amounts because a public company will almost never risk trial.[222] An industry will prefer principles that are broadly defined but unenforced than deal with principles that are the bases for substantial penalties.[223] An industry is thus likely to push for specific, predictable rules, perhaps combined with unenforced principles.

To the extent that some principle-enforcement is necessary, an industry perspective would prefer that principles are interpreted in a predictable way. For example, while FINRA Rule 2010, which requires FINRA members to act in accordance with "high standards of commercial honor and just and equitable principles of trade,"[224] is broadly worded, it is seen by some as a provision that should be mostly enforced in conjunction with specific rules rather than creating an independent basis for liability.[225] Such a view reflects the industry value of predictability.

"[t]he business community wants a sharp-edged safe harbor so that it can make disclosure decisions free of liability concerns.").

221. *See supra* discussion in Section II.A.

222. *See, e.g.*, Roger Lowenstein, *As Governor, What Would His Battles Be?*, N.Y. TIMES, July 16, 2006, at 6 (criticizing New York Attorney General for "leaking information about pending cases, using the threat of public humiliation to cajole defendants into settling, and never seeming to actually win a case at trial").

223. *See, e.g.*, Dale Arthur Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: "Are We There Yet?"*, 20 CARDOZO L. REV. 135, 163 (1998) ("An exchange that does not specifically enforce the language of its rules can afford to be imprecise and over-broad because no-one cares.").

224. *FINRA Rule 2010*, *supra* note 122. In the early years of SRO regulation, Rule 2010 was seen by some as providing SROs with greater enforcement potential than the SEC. *See, e.g.*, Louis Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 521 (1948) ("[W]hereas the Commission operates for the most part under rules phrased in terms of 'fraud,' the NASD is in a position to attack the problem of unreasonable spreads under the broader and more flexible 'high standards of commercial honor and just and equitable principles of trade.'").

225. A report by a committee on FINRA's examination program found differing attitudes toward FINRA Rule 2010. Some staff noted that "FINRA takes a conservative approach to using the rule in enforcement matters" while another attorney "indicated that Rule 2010 can be used expansively." CHARLES A. BOWSHER ET AL., SPECIAL REVIEW COMM., REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND

b. Industry Standards

In addition to predictability, an industry will also prefer an enforcement regime where it is judged by industry standards. Any reputable industry participant will have knowledge of such practices, giving it notice of what is or is not acceptable. Conduct that seems unwarranted by outsiders may in fact be necessary or economic from the perspective of the industry. Compliance with industry standards may also serve as evidence that questionable conduct does not reflect fraudulent intent. Principle-enforcement, when guided by industry values, will most likely defer to industry practices.

Rule-enforcement is attractive to the industry not only because it is more predictable but because it often reflects industry practices. Rules address specific industry-related concerns and are often influenced by the industry. Once adopted, rules can become an integral part of the peculiar language of the industry. Issues such as when a company must file a registration statement, when a broker must be licensed, and the level of a broker-dealer's capital requirements, are mostly the concern of those who participate or plan to participate in an industry. Few outside the securities industry will have much interest in knowing the specific content of such rules, and the violation of those rules will not be of much interest to outsiders.

Rules set forth clear requirements that an industry participant is expected to know and follow, and rule-enforcement helps ensure that rules are generally followed. A system of rules may be attractive to stronger industry participants as a way of separating out competent from incompetent participants. While rules in some cases may be a mechanism of maintaining oligopolistic power over an industry, there will be many cases where rules can result in high industry standards for conduct.

The usefulness of industry standards in defining a regulatory scheme has been emphasized in the New Governance scholarship. As Cristie Ford describes, "the essential components of a new governance approach are regulation that is informed and underpinned by a bottom-up, decentered, horizontal experimental process by private actors . . . ."[226] New Governance scholars contend that regulation is more effective when there is collaboration between industry and regulator that draws on the expertise of the industry.[227] Reliance on industry standards has long been a part of securities regulation and should continue to have an influence.

An enforcement approach influenced by industry values will not completely eliminate meaningful principle-enforcement. Principles can be

---

MADOFF SCHEMES 36 n.40 (2009).

226. Cristie Ford, *New Governance in the Teeth of Human Frailty: Lessons from Financial Regulation*, 2010 WIS. L. REV. 441, 445; *see also* Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 418–19 (2011) (noting the benefits of industry self regulation).

227. *See, e.g.*, Omarova, *supra* note 226, at 422–23.

enforced in a way that reflects a concern with maintaining practices of industry professionalism. For example, broker-dealers are subject to a broadly defined suitability requirement that requires them to assess the needs of their customers.[228] As noted before, Rule 2010 evidences a concern with "high standards of commercial honor and just and equitable principles of trade."[229] Underwriters, directors, and auditors have defenses to securities actions brought under Section 11 of the Securities Act of 1933 if they acted with due diligence, a concept that is defined in relation to industry practices.[230] Thus, principle-enforcement that is guided by industry values will still have a significant impact on industry conduct.

On the other hand, an enforcement approach motivated by industry values may become inadequate when industry practices evolve in a way that departs from acceptable societal norms. Industry enforcement may not be proactive enough to root out problematic conduct before it becomes prevalent. Enforcers should be wary of accepting industry practice defenses constructed by wrongdoers as an excuse for questionable conduct. It is inevitable that in some cases, industry conduct will have to be scrutinized in light of external values.

2. Regulatory Values

The securities industry is governed by an extensive regulatory scheme that is a delicate mix of rulemaking and enforcement of both rules and principles. Regulatory enforcement is distinctive in that a regulator must perform not only its enforcement duties but must balance enforcement against other concerns of the regulatory scheme. In enforcing broadly worded principles, a regulatory-values approach tends to emphasize two factors, consistency and regulatory policy.

a. Consistency

A regulator such as the SEC has responsibility not only for enforcement, but also for the administration of a comprehensive regulatory scheme using a wide array of tools.[231] There is pressure for a regulatory enforcer's efforts to be

228. *See National Association of Securities Dealers (NASD) Rule 2310: Recommendations to Customers (Suitability)*, FIN. INDUSTRY REG. AUTHORITY, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=3638 (last visited Nov. 29, 2011).

229. *FINRA Rule 2010*, *supra* note 122.

230. *See* Securities Act of 1933 § 11(b), 15 U.S.C. § 77k (2011).

231. *See, e.g.*, M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U. CHI. L. REV. 1383, 1386–89 (2004) (describing various administrative policy-making tools); David L. Shapiro, *The Choice of Rulemaking or Adjudication in the Development of Administrative Policy*, 78 HARV. L. REV. 921, 926–42 (1965) (describing administrative choice between rulemaking and administrative adjudication); *see also* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION TRANSCENDING THE DEREGULATION DEBATE 19–53 (1992) (noting variety of enforcement strategies available). *See generally* Sec. & Exch. Comm'n v. Chenery, 332 U.S. 194, 203 (1947) ("[T]he choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency.").

consistent with other aspects of the regulatory regime.[232] Moreover, each regulatory enforcement case should strive to be consistent with other regulatory enforcement cases. A regulator's consistency reflects its expertise and a coherent policy.[233]

In securities regulation, principle-enforcement occurs in the context of an extensive set of rules that have been constructed over time with the input of experts as well as the industry. The construction of a system of rules is a complicated and costly endeavor. An agency must develop expertise relating to an industry issue in order to determine that a rule is needed. The substantive content of the rule is subject to a notice and comment process.[234] The agency must craft the rule so it reflects the knowledge that it has accumulated.

Given the effort and process that accompanies rulemaking, rule-enforcement has a legitimacy that principle-enforcement may not enjoy. The process by which principles are enforced is not subject to the same public scrutiny as rulemaking. Many see regulation through enforcement in individual cases as a flawed way of making comprehensive law.[235] This perspective creates pressure to interpret principles narrowly in a way that is consistent with the specific nature of rules. The argument might be that it makes little sense to have a system of rules if the regulator can circumvent the rulemaking process by enforcing broadly worded principles.

Innovative principle-enforcement may be discouraged by an approach that emphasizes regulatory values because of a desire for consistent application of the law. A regulator may feel locked into its past practices and positions and as a result might act too cautiously. The need for consistency partly motivates the SEC's use of a bureaucratic structure. A hierarchal structure with its multiple levels of review helps check a regulator from acting arbitrarily in its enforcement efforts. Rule-enforcement may be seen as more objective and consistent while principle-enforcement might be perceived as subjective and haphazard. Ultimately, while consistency may be necessary for a regulatory enforcer, a focus on consistency can limit the effectiveness of enforcement efforts.

---

232. *See, e.g.*, Langevoort, *supra* note 126, at 527 (noting early criticism of SEC policy for disharmony).

233. Therefore, courts do not give deference to inconsistent agency interpretations of regulations. *See, e.g.*, Sec. & Exch. Comm'n v. AFSCME, 462 F.3d 121, 129 (2d Cir. 2006) (refusing to defer to SEC position on shareholder proposal regulation because of SEC's inconsistent position) (citing Thomas Jefferson Univ. v. Shalala, 512 U.S. 504, 515 (1994)).

234. Administrative Procedure Act, Pub. L. No. 79-404, 60 Stat. 238 (1946).

235. *See, e.g.*, Frederick Schaeur, *Do Cases Make Bad Law?*, 73 U. CHI. L. REV. 883 (2006) (describing limits of making law through case-by-case adjudication). *But see* Jeffrey J. Rachlinksi, *Rulemaking Versus Adjudication: A Psychological Perspective*, 32 FLA. ST. U. L. REV. 529, 531 (2005) (noting that both rulemaking and adjudication have "advantages and disadvantages" for an administrative agency).

b. Regulatory Policy

As with any administrative agency, a regulator such as the SEC is likely to interpret principles in a way that reflects its overall regulatory policy. In particular, the SEC is required to consider whether its rules and actions protect investors and "promote efficiency, competition, and capital formation.''[236] Enforcement is not an end in itself but one of an array of measures that can be utilized in shaping industry conduct.

In contrast to principle-enforcement, rule-enforcement can almost always be linked to regulatory policy. The specificity of rules usually reflects a consensus based on the regulator's negotiation with the industry as to a desirable rule. By enforcing the rules, a regulator can effectuate the policy that motivated the passing of such rules. Rule-enforcement is necessary in order for the rule regime to have meaning. The construction of a system of rules makes little sense if firms can violate or ignore those rules without fear of sanction.

Principle-enforcement can also serve regulatory policy. By punishing misconduct that falls in gray areas of the law, regulators can send a message that firms are not just accountable for following clearly defined rules. Aggressive enforcement effectuates a policy of encouraging integrity in the marketplace. On the other hand, the subject of enforcement might argue that given the regulator's failure to define the relevant norm adequately, a better regulatory response might be to excuse the conduct and pass a rule making it clear that such conduct is prohibited in the future.[237]

Principle-enforcement can be in tension with other concerns that the regulator must take into account. The SEC is responsible for encouraging an efficient and healthy securities market. The expense of defending enforcement actions can sap resources from firms and might create market turmoil.[238] The regulatory system may be in competition with other regimes that offer less vigorous enforcement as an inducement for firms. An example of the influence of such competing concerns is the criticism the SEC has faced for aggressively seeking significant penalties through enforcement.[239] Critics have argued that the cost of such penalties is not warranted, given that innocent shareholders

236. National Securities Markets Improvement Act of 1996, § 106, Pub. L. No. 104-290, 110 Stat. 3424 (1996).

237. *See, e.g.*, Pitt & Shapiro, *supra* note 97, at 167 ("In a proper context, an administrative agency should define normative standards first, offer interpretive guidance second (to the extent feasible), and compel obedience to those standards as a last resort, when it is clear that those standards have been well publicized and comprehended, but disregarded.").

238. *See, e.g.*, Coffee & Sale, *supra* note 53, at 724 (noting "[i]t approaches the self-evident to note that a conflict exists between the consumer protection role of a universal regulator and its role as a 'prudential' regulator intent on protecting the safety and soundness of the financial institution").

239. *See* U.S. CHAMBER OF COMMERCE, *supra* note 5, at 26–30 (criticizing SEC's willingness beginning in 2002 to impose significant penalties on public companies).

bear some of the cost of such penalties.[240] These are policy arguments and ones that the SEC must take into account when crafting its enforcement approach.

3. Public Values

While enforcement approaches motivated by industry and regulatory values focus on internal concerns and policies, some enforcers see their job as enforcing public values with meanings that may be external to the industry and regulatory system. A public-values approach to enforcement requires the firm to anticipate the application of societal norms to its conduct.

a. The Burden of Anticipation

While industry values emphasize predictability in enforcement, most regulatory regimes require the regulated to anticipate the application of broader principles by regulators exercising their discretion—though as noted earlier, the cost and controversy of principle-enforcement will discourage some regulators from enforcing principles. No system of rules is comprehensive because constructing a comprehensive scheme would simply cost too much and would also impose too many arbitrary restraints on the industry. Enforcement of broadly worded principles can be useful in regulating an industry that is as complex and ever changing as the securities markets. Principle-enforcement may allow for simpler rules in that regulators do not have to anticipate every form of potential misconduct.[241]

Principles, though, come at a cost. They require firms to anticipate whether their conduct will run afoul of broadly worded provisions that can be interpreted in light of different values. For former SEC Chairman and Columbia Law Professor William Cary, securities and corporate law has an essential element that is anticipatory.[242] Cary argued that companies and their counsel should not only accept that public opinion influences regulation, but that they should anticipate what type of conduct would result in public outcry that could lead to backlash.[243] As much as an industry would prefer to operate by its own practices and the regulatory policies that it negotiates, any regulatory scheme is subject to the influence of ex post enforcement that must be anticipated. Cary's approach is representative of an anticipatory approach.

The degree of anticipation required by principles is lessened if principles are interpreted in accordance with industry practices and regulatory policy. The regulated firm can examine those practices and policies in coming to an

240. *See, e.g.*, Sec. & Exch. Comm'n v. Bank of Am. Corp., 653 F. Supp. 2d 507, 509 (S.D.N.Y. 2009) (asserting that SEC penalty harms shareholders who are victims of the fraud).

241. *See, e.g.*, David A. Weisbach, *Formalism in Tax Law*, 66 U. CHI. L. REV. 860, 882 (1999) (noting that anti-abuse provisions allow for simpler tax rules).

242. *See* Cary, *supra* note 111, at 417–18.

243. *See id.* at 418 ("But should not management and their counselors anticipate not only the laws that may result from aroused public opinion, but events that will arouse that opinion?").

understanding of what the principle means. The difficulty of anticipation comes when principles are interpreted in reference to broader values by enforcers who are not as deferential to industry and regulatory understandings.

b. Societal Norms

A public-values approach will not only require anticipation on the part of the industry, but will push for the interpretation of principles in accordance with societal norms rather than solely based on industry standards. A public-values approach will view principles as reflecting common sense morality rather than the technical concerns of a complex, administrative framework.[244] Prohibitions against fraud, breaches of duty by fiduciaries, and theft are not just part of securities regulation but reflect common social norms that are reflected in the common law.[245] A public-values approach will view principle-enforcement as ensuring that societal values remain relevant.[246]

Additionally, a public-values approach will tend to view each case individually on the merits, rather than assessing its place within a broader regulatory scheme. Cost-benefit analysis is not as relevant when societal norms are intentionally violated. In certain circumstances, such norms will trump concerns raised by industry standards and regulatory policy. Under a public-values approach, principle-enforcement can express certain values such as the condemnation of fraud and unjust enrichment that have significance apart from the regulatory scheme.[247]

Application of public values through principle-enforcement can be controversial to the extent that it upsets common understandings based on industry and regulatory values. Principle-enforcement that reflects a public-values approach might be fueled by uninformed populism that leads to unfairness as some individuals are singled out for conduct they believed was consistent with industry standards. On the other hand, populism might be

244. It has been observed that rules tend to be associated with individualism while principles are associated with communitarianism. *See, e.g.*, Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1713–37 (1976).

245. *See, e.g.*, Blue Chip Stamps v. Manor Drug Stores, Inc., 421 U.S. 723, 744–56 (1975) (discussing relationship between common law torts and Rule 10b-5); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post*-Chiarella *Restatement*, 70 CALIF. L. REV. 1, 18–26 (1982) (discussing fiduciary and unjust enrichment principles as basis for Rule 10b-5 insider trading prohibition); Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 364–81 (1984) (describing the parallel between common law restitution and Rule 10b-5 remedies).

246. *See* Owen Fiss, *The Supreme Court: 1978 Term*, 93 HARV. L. REV. 1, 2 (1979); *see also* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1063 (1997) (describing the role of Delaware courts in defining norms).

247. An analogy can be drawn here to the expressive function served by criminal law. Like principles, criminal law tends to express public values that go beyond costs and benefits. *See, e.g.*, Kahan, *supra* note 16, at 484 ("But notice is much less important when the law is regulating clearly undesirably conduct; potential offenders don't need the *law* to tell them that theft or organized criminality is wrong, because *ordinary* morality suffices.").

defused by sanctioning the worst forms of misconduct, thereby signaling that corruption in the markets can be addressed through existing legal principles rather than revamping the entire regulatory infrastructure.

B. An Uneasy Balance

A case can be made that any enforcement system should take all three values into account. On the other hand, any system that values all three approaches will encounter situations where they clash with one another. These tensions are especially likely in the context of principle-enforcement, both with respect to decisions about whether to bring a case, as well as decisions about the allocation of investigative resources.

In many situations, all will agree that conduct is inconsistent with industry standards, regulatory policy, and public values. It should be entirely predictable that stealing client funds violates rules and principles, as well as industry, regulatory, and public values. An enforcement case severely sanctioning such conduct will not be controversial. Indeed, enforcers often coordinate their efforts in bringing cases where there is consensus that the conduct should be sanctioned.[248]

On the other hand, there is a fundamental tension between an approach that emphasizes predictability and one that emphasizes the burden of anticipation. To the extent an industry-values approach dominates, there will be less of an emphasis on anticipating how principles will apply to novel forms of misconduct. To the extent a public-values approach dominates, there will be less of an emphasis on creating a stable regime. A regulatory approach could be a middle ground between an industry-values and public-values approach, but it might be impossible to resolve the conflict between predictability and anticipation given the need for regulatory consistency.

The pressure to bring enforcement cases in times of economic turmoil might contribute to value disagreements, but may also result in greater unity among approaches. Political pressure is likely to induce more aggressive assertion of public values against industry conduct. An industry or regulatory approach may be seen as too cautious in changing industry norms. On the other hand, enforcers might be most likely to agree that action is necessary in times of economic distress.

Enforcement conflict is likely to arise in cases involving conduct that occurs in gray areas that are not clearly covered by an applicable rule. For example, as noted earlier, accounting standards give management significant discretion in preparing financial statements.[249] An accounting treatment may

248. Indeed, as noted earlier, securities laws envision such cooperation with respect to cases that may rise to the level of criminality. *See supra* note 183.

249. *See, e.g.*, Godchaux v. Conveying Techniques, Inc., 846 F.2d 306, 315 (5th Cir. 1988) (noting that GAAP "tolerate[s] a range of 'reasonable' treatments, leaving the choice among alternatives to management").

arguably be consistent with what the industry has done in the past, but it may also be part of a scheme to defraud investors. An industry-values approach might simply give the benefit of the doubt to management. A regulatory approach might ask whether other regulatory pronouncements have prohibited the behavior and whether enforcement would further a broader policy. A public-values approach would more aggressively seek to sanction such conduct as inconsistent with societal values.

The approaches might differ in deciding whether to bring a case, as well as the sanctions that would be appropriate. An industry-values approach might contend that because the conduct was consistent with industry practice, it should not be the subject of enforcement. A regulatory policy approach might contend that enforcement is still appropriate, but given the uncertainty of the law, only a minimal sanction should be imposed. A public-values approach would likely argue that the defendant should have anticipated the wrongness of the conduct and that significant sanctions are appropriate.

There are at least two ways in which enforcement approaches can conflict. First, direct conflict can arise when different enforcers seek to bring cases regarding the same conduct. Disputes might arise concerning the type of sanctions that might be appropriate. An enforcer influenced by a public-values approach might contend that higher sanctions are warranted than an enforcer guided by an industry-values approach, who might favor a more cooperative approach.[250] Second, a more indirect conflict arises when an enforcer brings a case when another enforcer chooses not to bring a case. The decision to bring a case might be read as disrupting the policy or authority of the enforcer that chose not to exercise its discretion to bring a case.

Enforcement approaches differ not only in the decision to bring a case, but also with respect to investigative decisions. Few enforcers would allow a case with strong evidence of misconduct to expire without action. The more critical differences in principle-enforcement may arise in deciding how investigative resources are deployed in developing the facts necessary to establish a violation of a principle. An industry-values approach may simply take industry explanations on face value without spending many resources to verify whether such explanations are valid. A regulatory-values approach will be more skeptical, but may also be wary of imposing investigative costs on an industry. A public-values approach is likely to be the most aggressive in pursuing leads of misconduct, but may also be less sensitive to the costs imposed on the targets of the investigation.

Though enforcement is motivated by different approaches and enforcers can coexist, there will be difficult cases where the appropriate approach is uncertain because enforcers are influenced by different values. In such cases

250. *See, e.g.*, Rose, *supra* note 30, at 1336 (noting the possibility that the SEC will take a cooperative approach to enforcement).

the decision to bring a case or impose sanctions might create conflicts between enforcers and the values that motivate their approach. Conflicts will also arise about the decision to deploy investigative resources. The choice between centralized and decentralized enforcement is fundamentally about eliminating, managing, or allowing such conflicts to arise.

V.
THREE ENFORCEMENT MODELS

Earlier, this Article discussed proposals for centralizing securities enforcement either through consolidation or greater supervision of enforcers. It might be said that there are three enforcement models: consolidated enforcement, supervised enforcement, and decentralized enforcement, each reflecting different degrees of centralization. In this Part, I analyze these models in light of the distinction between rule-enforcement and principle-enforcement, as well as the competing enforcement values previously discussed. These three enforcement systems essentially differ in their tolerance for plurality of enforcement values.

A. Consolidated Enforcement

Under a consolidated enforcement model, multiple enforcers would be eliminated in favor of one enforcer. Consolidation is attractive because it should result in a uniform approach to enforcement handled by an expert. Strike suits would likely be minimized, as well as aggressive principle-enforcement that causes conflict when public values are used to question industry standards or the regulatory regime. An expert regulator would draw upon rulemaking, rule-enforcement, and principle-enforcement to implement a consistent regulatory policy. Any principle-enforcement could be conformed to industry or regulatory values so it is predictable and consistent.

A danger of such a monopolistic enforcer is that enforcement would tend to solely express industry or regulatory values. Such a tendency will be especially problematic when industry practices evolve in a way that tolerates wrongdoing. Industry and regulatory enforcers may be too slow to react. An SRO enforcer is likely to defer to industry practices. The SEC might be less willing to defer to industry practices but can be constrained from acting aggressively because of its bureaucracy and role as an expert regulator that is held to a standard of consistency. As a result, with consolidated enforcement, it is more likely that industry conduct and regulatory policy will have a narrow focus that drifts away from public values.[251]

251. To be fair, the proponents of centralization do not argue that federal prosecutors should not have a role in securities enforcement. Even with centralization, federal prosecutors could still bring criminal cases enforcing public values. Of course, the high standard for criminal liability reduces the ability of federal prosecutors to consistently play an active role in enforcement. Moreover, the fact that centralization proposals envision that federal prosecutors will play a role seems to concede that there is

Moreover, any monopolistic enforcer would be subject to its particular institutional constraints. The SEC is burdened by its bureaucratic structure and the task of administering a regulatory system. SROs have the disadvantage of relying upon funding from the industry. Consolidation would likely mean that investigations and enforcement would take on more of a uniform character that will lack creativity and initiative. The advantage of smaller, nimbler enforcers that root out evidence of wrongdoing would be lost.

The SEC might be more attractive as a monopolistic regulatory enforcer if its enforcement approach is reformed so it can more effectively enforce principles. In response to criticisms about its approach to enforcement, the SEC has taken steps to reduce the levels of bureaucracy that stifle innovative investigations and enforcement. Authority to issue subpoenas has been delegated from the Commission to supervising enforcement attorneys.[252] There also seems to be an effort on the part of the SEC to reinvigorate its role as an advocate for the investor.[253] It is unclear whether such a shift will make a difference, but perhaps the SEC as an advocate for the investor would be less reluctant to express public values.

Despite these reforms, controversial enforcement has still been difficult for the SEC. Some saw the SEC's aggressive enforcement action against Goldman Sachs for failure to disclose certain facts about a complicated mortgage security to institutional investors as reflecting a new enforcement approach by the SEC.[254] The case was especially controversial because it involved what were allegedly accepted industry practices and the victims were sophisticated investors.[255] The SEC has traditionally focused on protecting unsophisticated rather than sophisticated investors and so the SEC's case was arguably not consistent with prior regulatory policy.[256] Though the case resulted in a significant penalty, the more controversial Rule 10b-5 charge was dropped and the settlement was met with significant resistance by two of the five SEC Commissioners.[257] Despite its qualified success, the Goldman Sachs case is an example of the difficulty a regulatory enforcer can have with

---

room for additional enforcers.

252. *See* Scannell, *supra* note 127. For an analysis of efforts to reform the SEC, see Joan MacLeod Heminway, *Reframing and Reforming the Securities and Exchange Commission: Lessons from Literature on Change Leadership*, 55 VILL. L. REV. 627, 632–36 (2010).

253. The Chairman of the SEC has emphasized the importance of investor protection. *See* Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, Evolving to Meet the Needs of Investors, Address to Practising Law Institute's *SEC Speaks in 2011* Program (Feb. 4, 2011), *available at* http://www.sec.gov/news/speech/2011/spch020411mls.htm. This is not a new role for the SEC. Commentators have long observed that there is a strong investor protection culture at the SEC. *See, e.g.*, Choi & Pritchard, *supra* note 8, 34–35.

254. The firm complained it was "blindsided" by the lawsuit. *See* Susanne Craig et al., *Firm Contends It Was Blindsided by Lawsuit*, WALL ST. J., Apr. 19, 2010, at A1.

255. *See, e.g.*, Brooke Masters & Rachel Sanderson, *SEC Case Comes to Rare Aid of "Sophisticated Investors,"* FIN. TIMES, Apr. 21, 2010, at 16.

256. *See, e.g.*, *id*.

257. *See, e.g.*, Scannell & Craig, *supra* note 109.

bringing a principle-enforcement case that is perceived as inconsistent with industry standards and prior regulatory policy.

Another example of the difficulty of change is the criticism of the SEC when it imposes significant penalties on public companies through enforcement.[258] Large penalties may be seen as inconsistent with the SEC's regulatory role for two reasons. First, penalties tend to be arbitrary in size and are thus difficult to impose in a consistent way as demanded by regulatory policy. Second, penalties can drain resources from public companies, increasing the costs of regulation in a system that values efficiency. As a result, it is questionable whether the SEC on its own can adequately enforce the securities laws while being true to its role as an objective, expert, and consistent enforcer.

At some level, radical institutional reform of the SEC is unrealistic. Part of the SEC's difficulty with pursuing timely principle-enforcement is the requirement that five Commissioners review and approve every enforcement action.[259] No matter how industrious, it is difficult to see how five individuals can make meaningful decisions on hundreds of complex enforcement actions a year on a timely basis. Such review, however, is arguably necessary for a regulatory enforcer such as the SEC to have a consistent regulatory policy. Substantially decentralizing SEC enforcement would make it difficult for the SEC to function as an expert, regulatory enforcer. Expertise comes at a cost, less ability to enforce aggressively. Innovative enforcement must come from some other source.

B. Supervised Enforcement

Rather than totally consolidating enforcement, an intermediate solution to the problem of conflict between multiple enforcers is to give the regulatory enforcer greater power to supervise enforcers, especially entrepreneurial enforcers. In doing so, a securities enforcement regime might have the best of both worlds, decentralized enforcers that can vigorously enforce principles, while giving the regulatory enforcer greater power to implement a consistent regulatory policy.

One method of supervision might be to give the regulatory enforcer more power to define the law governing entrepreneurial enforcers. Recall that under the Grundfest proposal, the SEC would more actively shape the law governing private securities class actions.[260] To some extent, Grundfest's argument rested on the assumption that Congress would be unwilling to act in implementing

258. *See* U.S. CHAMBER OF COMMERCE, *supra* note 5, at 26–30.

259. *See supra* note 129.

260. Similarly, Daniel Crane has argued that antitrust law should become more rule-like to check the costs of private antitrust actions. *See* Daniel A. Crane, *Rules Versus Standards in Antitrust Adjudication*, 64 WASH. & LEE L. REV. 49 (2007).

meaningful reform.[261] Subsequent to the publication of Grundfest's article, Congress and the courts crafted substantial limits that now govern private class actions.[262] Most significantly, when bringing a securities class action, entrepreneurial enforcers are required to plead "a strong inference" of scienter or the case will be dismissed.[263] Such a heightened pleading standard limits the tendency of entrepreneurial enforcers to bring suits based on questionable assumptions of fraud.

The question is whether there are further limitations that the SEC can implement while maintaining Rule 10b-5's form as a principle. For Grundfest's proposal to do more work, one must believe that Rule 10b-5 can be further defined through specific rules without losing its essential character as a prohibition of fraud.[264] At a practical level, especially after the reforms passed by the PSLRA, the only significant contribution that a strategy of rulemaking might have would be to essentially eliminate private actions entirely.[265] Such an effort would look more like consolidation rather than supervision.

Another possibility would be to implement a more direct form of supervision over entrepreneurial enforcers. Rose's proposal would act more directly in screening securities class actions than Grundfest's proposal. Instead of using rulemaking, the SEC would have the power to decide whether a securities class action is consistent with regulatory policy. In a sense, Rose's proposal would delegate interpretation of Rule 10b-5 from the courts to an administrative agency. The proposal relies on the assumption that the SEC has a meaningful advantage over courts in screening out cases without merit.

Indeed, as with Grundfest's proposal, for Rose's proposal to significantly reduce costs, the SEC would need to formulate additional limits that go beyond what the courts have already promulgated. It is questionable whether such limits exist. If easy criteria to screen cases existed, the legislature and courts would already have implemented them. Assessing the merits is an inherently difficult task, not because the courts do not have expertise that the SEC has, but because at the screening stage before discovery, the facts are undeveloped. It is unclear why the SEC would be much better in assessing cases at the pre-discovery stage than courts.

---

261. *See, e.g.*, Grundfest, *supra* note 16, at 1019 ("In the sixty years since the Commission was created, Congress has repeatedly demonstrated its inability to resolve significant policy issues related to securities fraud litigation.").

262. *See* Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended at 15 U.S.C. §§ 77a-1 to 78u-5).

263. *See* 15 U.S.C. § 78u-4(b)(2)(A) (2011).

264. The SEC has already tried through rulemaking to define the scope of the insider trading prohibition, SEC Rule 10b-5-1, but the rules have been criticized as not clarifying insider trading law. *See, e.g.*, Nagy, *supra* note 156, at 1352–64.

265. Indeed, at least one of Grundfest's proposals is in the nature of eliminating rather than managing entrepreneurial enforcement. *See* Grundfest, *supra* note 16, at 1015 ("[B]y sharply limiting or eliminating the right to claim monetary damages in certain circumstances, the Commission could effectively eliminate plaintiffs' incentive to bring suit for anything other than equitable relief.").

In addition, the Rose proposal would need to be accompanied by additional reform of the SEC's bureaucracy. If the SEC has difficulty processing cases on a timely basis when it is dealing just with its own enforcement efforts, it would have even more difficulty doing so with the addition to its docket of two hundred or so class actions a year. It may be that subjecting entrepreneurial enforcers to the bureaucracy of the SEC would reduce if not eliminate the advantages of decentralized enforcement.

Proposals to supervise enforcement share a belief that an expert administrative agency can shape a broadly worded principle so its application can be predictable and rule-like. It is questionable whether further definition is possible without reducing the principle to a formalistic rule. Moreover, the application of expertise comes with a cost, increased bureaucratization of the decision-making process.

C. Decentralized Enforcement

The current system of decentralized enforcement has its advantages, but it also has its costs. Multiple enforcers allow for the expression of the full range of values through enforcement, but the cacophony of voices can interfere with regulatory policy and unduly disrupt industry standards. However, the extent of such disruption may be isolated and manageable.

An advantage of a system with multiple enforcers is it allows for aggressive enforcement, while allowing regulatory enforcers such as the SEC to preserve its reputation for bureaucratic neutrality. Jonathan Macey's application of public-choice theory to the question of federal preemption is useful in framing this argument.[266] Macey observes that Congress can have an incentive to defer to states or administrative agencies, rather than preempting them with federal legislation, to avoid controversy on difficult regulatory matters.[267] Similarly, the SEC has an incentive to defer to other enforcers in aggressively investigating allegations of securities fraud and bringing cases that may take years to resolve. A system of multiple enforcers allows the SEC to avoid getting its hands dirty while it saves political capital for other regulatory efforts. By delegating to public-values and entrepreneurial enforcers, the SEC preserves its reputation for objectivity and expertise, while the wrongdoer is brought to justice.[268]

On the other hand, it is difficult for the regulatory enforcer to maintain its neutrality when public-values and entrepreneurial enforcers are wildly successful. The regulatory enforcer may have no choice other than to follow with

266. *See* Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265 (1990).

267. *Id*. at 284–85.

268. For a proposal that the SEC should outsource difficult cases to the private sector, *see* Tamar Frankel, *Let the Securities and Exchange Commission Outsource Enforcement By Litigation: A Proposal*, 11 J. BUS. & SEC. L. 111, 119–25 (2010).

aggressive efforts of its own in order to maintain its credibility, undermining the regulatory value of consistent application of regulatory policy. As a result, public-values and entrepreneurial enforcers can disrupt regulatory policy.

There are reasons to believe, however, that this is not such a serious problem. The pressure to ratchet up enforcement has mostly come from public-values enforcers such as federal prosecutors and state attorneys general. Especially when political motivations are present, some public-values enforcers are not shy in trumpeting their successes and criticizing the SEC. On the other hand, active enforcement by public-values enforcers is limited to certain contexts, especially when public attention is focused on corruption and fraud in the markets. When such periods subside, federal prosecutors and state attorneys general fade back into the distance. Because they do not primarily focus on securities enforcement, federal prosecutors and state attorneys general are not always asserting enforcement authority in a way that disrupts regulatory policy. Government actors may also be responsive to public concerns and backlash concerning excessive enforcement.[269] The pattern seems to be that after a wave of intense activity by public-values enforcers, the SEC again emerges as the primary securities enforcer.

In contrast, entrepreneurial enforcers are not likely to put as much pressure on the SEC to act. Most class action settlements take years to complete, often when public attention is drawn elsewhere. As a result, the potential for directly interfering with SEC enforcement policy may be minimal. The problem of the entrepreneurial enforcer, while significant, is mostly an issue of costs to the system rather than significant interference with regulatory policy. The class action attorney as entrepreneur has long been criticized for seeking his interests rather than the interests of clients or the public good.[270] Unlike public-values enforcers, entrepreneurial enforcers do not have the luxury of scaling back their enforcement activity. To some extent, there will always be cases of questionable merit filed because of the need of a class action attorney to keep his business running.[271]

While an ideal regulatory policy might eliminate unwarranted costs, it is unclear that some inefficiency in the system, even if significant, hinders the ability of a regulatory enforcer to do its job. Moreover, any costs to the system must be weighed against the benefits of entrepreneurial enforcers' willingness

269. *See, e.g.*, Jones, *supra* note 54, at 110 ("Although regulatory competition may sometimes spur more vigorous enforcement action, the political process also works to constrain excessive regulatory zeal and commands diverse regulators to work together to protect the public interest.").

270. *See, e.g.*, John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 96–105 (1991).

271. There is evidence that the PSLRA has resulted in the filing of fewer cases without merit. *See* Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1486–99 (2004) (summarizing studies).

to invest significant resources in litigating complex cases for years. Intermediate measures, such as more aggressive screening by courts, might be the better way to manage the costs of entrepreneurial enforcement rather than eliminating multiple enforcers. It is telling that the SEC has consistently supported private class actions as a necessary supplement to public enforcement.[272] In the view of the primary regulatory enforcer, entrepreneurial enforcers do not significantly hinder regulatory policy.

VI.
A COMPARATIVE ADVANTAGE SYSTEM OF ENFORCEMENT

The choice between a centralized and decentralized system of enforcement is fundamentally one between a one-dimensional and multidimensional conception of enforcement values. Should securities enforcement be controlled by one enforcer with its expert approach to enforcement, or should we allow for the expression of a greater diversity of values by multiple enforcers?[273] The contribution of this Article is not so much to resolve this debate, but to frame it in a way that is richer and perhaps fairer to the system of multiple enforcers that currently exists. In essence, the argument of the Article thus far has been to set forth a comparative advantage theory of enforcement. This Part more fully describes that theory and proposes a two-tier system of enforcement that might better utilize the comparative advantages of enforcers.

As noted earlier, the debate over the structure of securities enforcement has been centered on the issue of overenforcement. The major limitation to this approach is it does not do enough to emphasize the qualitative differences of enforcement efforts. If enforcement is a uniform product, the case for a monopolistic enforcer is much stronger than if enforcement quality differs.

The distinction between rule-enforcement and principle-enforcement suggests that different enforcers will be effective in different ways. Principle-enforcement hinges on effective fact development, which cannot be reduced to a bureaucratic science. Building a case is not a formulaic exercise but requires creativity, a willingness to take risk, as well as quite a bit of luck. It is difficult to say that the thorough, process-driven approach of the SEC will always be better in developing compelling principle-enforcement cases than the entrepreneurial approach of other enforcers.

The case for multiple enforcers can be made by emphasizing the unique advantages enforcers bring to the table. Though enforcers compete at times for

272. *See, e.g.*, Pritchard, *supra* note 34, at 1085.

273. *Cf.* Richard H. Pildes & Elizabeth S. Anderson, *Slinging Arrows at Democracy: Social Choice Theory, Value Pluralism, and Democratic Politics*, 90 COLUM. L. REV. 2121, 2143 (1990) ("Value pluralism is the view that public values—those values at stake in political choice—ought to be understood to be diverse in a particular and profound way: these choices typically implicate very different *kinds* of values or even very different *conceptions* of values.").

publicity and control of the same cases, for the most part, they usually perform the particular tasks that they are better suited for. Industry enforcers develop and enforce industry norms. The SEC enforces in a way that sets forth a coherent regulatory policy, acting slowly but surely as a large bureaucracy. Public-values enforcers can nimbly police the worst forms of conduct that offend societal values, taking advantage of their independence from regulatory burdens. Entrepreneurial enforcers motivated by profits are willing to enter into trench warfare with companies who hide behind their complexity in insisting they have done nothing wrong. The value of multiple enforcers is not just that they spur the SEC to act through competition, but that they have their own approach to enforcement that the SEC will find difficult to replicate.

While in theory one enforcer could perform all of these tasks, the economic theory of comparative advantage would suggest it would be better to delegate certain tasks to specialists.[274] It might be more efficient for the SEC to focus on rule-enforcement and regulatory policy, while allowing smaller, risk-taking enforcers to focus on principle-enforcement that expresses public values. The cost and controversy of principle-enforcement can distract the SEC from performing its regulatory functions. By targeting its efforts at what it does best, the SEC would be better able to focus on performing its core function of setting regulatory policy.

Securities enforcement could be structured as a two-tiered system where different enforcers focus on distinct kinds of enforcement. The first tier would include industry and regulatory enforcers who primarily focus on rule-enforcement. The second tier would include public-values and entrepreneurial enforcers who primarily focus on principle-enforcement. It is likely, under such a system, that one tier would sometimes be more active than the other, depending on the economic and political climate. In general, perhaps the first tier of industry and regulatory enforcers would dominate, but when scandals erupt or corruption is evident, the second tier would emerge and play a greater role.

Such a system should not entirely preclude first-tier enforcers from principle-enforcement. First-tier enforcers might still engage in principle-enforcement in cases where second-tier enforcers do not have the incentives or resources. One such area might be cases involving enforcement against individuals without the profile or deep pockets to attract involvement by second-tier enforcers.[275] Another possibility is that first-tier enforcers could

274. For examples of applications of the theory of comparative advantage to a legal context, see Kenneth B. Davis, *Corporate Opportunity and Comparative Advantage*, 84 IOWA L. REV. 211 (1999); Frank H. Easterbrook, *Does Antitrust Have a Comparative Advantage?*, 23 HARV. J.L. & PUB. POL'Y 5 (1999).

275. Much of the SEC's public values activity occurs with respect to issues such as insider trading against individuals. Donald Langevoort has argued that the SEC's insider trading campaign is a way of creating a "brand" that capitalizes on an issue with public appeal. Donald C. Langevoort, *Rereading* Cady, Roberts*: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1328–29 (1999); *see also* KHADEMIAN, *supra* note 150, at 14–17 (noting that insider

limit their principle-enforcement efforts to prospective relief and leave collection of monetary remedies to second-tier enforcers. The SEC would not be as subject to criticism for lack of consistency if its efforts were primarily injunctive, with costly and controversial follow-up litigation performed by private parties.

Of course, a system that relies on the comparative advantages of multiple enforcers will still potentially have values conflicts. Enforcers in the first tier will feel pressure to follow successful principle-enforcement efforts by second-tier enforcers, though such pressure might be reduced if it were widely understood that first-tier enforcers mainly focused on rule-enforcement. Another challenge is that second-tier enforcers might overreach in ways that interfere with regulatory policy.

In order to manage these conflicts, first-tier enforcers such as the SEC might be given some additional power to influence principle-enforcement so it does not stray too far from regulatory policy. Coffee and Sale have sensibly proposed giving the SEC power to invalidate injunctive relief by state securities regulators that unduly interferes with the SEC's regulatory policy.[276] In addition, the SEC could be given the power to make a concurrent filing in any securities enforcement case brought by any enforcer that gives its opinion as to the merit of the case and whether it is consistent with regulatory policy. Courts and parties could use the SEC's opinion as a strong signal in deciding whether a case has merit. A system that allows the SEC to give its input would allow it to influence cases brought by other enforcers, while reducing some of the bureaucracy that might result from a more formal review. Finally, regulators should continue to consider criteria that will guide their decision to bring principle-enforcement cases.[277]

An objection to limiting the SEC's role in the context of principle-enforcement might be that the SEC has a special legitimacy in enforcing principles. Regulatory policy has at least some place for public values, and SEC enforcement often effectively reflects public values. Such concerns might be lessened by the fact that the SEC would still bring principle-enforcement cases against individuals. In the most egregious cases, it should be possible to identify individuals who can be targeted. The SEC can also proceed with rule-enforcement against companies, and there should be sufficient incentive for values or entrepreneurial enforcers to bring principle-enforcement cases against companies. Admittedly, something would be lost if the SEC did not enforce principles against companies, but such a loss might be outweighed by the benefits of allowing the SEC to focus on its particular role as a regulatory enforcer.

---

trading cases "give the SEC, an agency with limited resources, additional leverage in preempting future fraud and manipulation").

276. *See* Coffee & Sale, *supra* note 53, at 780.

277. In an earlier article, I proposed such criteria. *See* Park, *The Competing Paradigms of Securities Regulation*, *supra* note 82.

Different enforcers have different advantages, and a decentralized system allows for specialization in enforcement approaches. A pluralistic approach to enforcement can create a dialectic between expert and non-expert; rule-enforcer and principle-enforcer; low-risk enforcer and high-risk enforcer; the bureaucratic and entrepreneurial; and results in a rich level of enforcement activity. Certainly, there will be times when one tier dominates the other. When all is quiet on the enforcement front, the first-tier enforcers will tend to predominate. When scandals erupt and corruption is evident, the second tier will reemerge and play a greater role. But for the most part, there will be a mix of rule-enforcement and principle-enforcement and a two-tier system might allow enforcers to better define and express their comparative advantages.

CONCLUSION

An outside observer encountering the U.S. system of securities enforcement might see chaos and duplication. While that may be the case, there is a method to the madness, though there is significant room for improvement. The securities enforcement system we have reflects diverse industry, regulatory, and public values. Different enforcers play different roles in expressing these values.

Far from being a uniform product, enforcement differs greatly based on its quality. Any regulatory system needs the development and enforcement of rules that define the particulars of the administrative scheme. At the same time, broader principles provide a framework for ensuring that certain value considerations remain relevant.

It is with principle-enforcement that we see the greatest variation in enforcement. The need for predictability and consistency can conflict with a desire to punish conduct that runs afoul of public values. Such conflict has motivated the push to centralize securities enforcement. Though eliminating conflict has its benefits, there are costs to doing away with the comparative advantage of diverse enforcers who do not operate under the same constraints as a regulatory enforcer such as the SEC. The key to defining an optimal system lies in understanding the dynamics of principle-enforcement and recognizing the benefits of multiple enforcers, while crafting a system that better defines the boundaries within which securities enforcers operate.