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THE BANKRUPTCY OF THE SECURITIES MARKET PARADIGM

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ABSTRACT

The current paradigm of securities market regulation in the United States rests on the Efficient Market Hypothesis, a theory that has been largely discredited by modern economics and behavioral finance. The Efficient Market Hypothesis assumes that the price of securities in the market accurately incorporates and reflects all available material information. Building on this notion, regulators have assumed that better information leads to healthier markets—and therefore regulation that enhances disclosure and transparency leads to healthier markets. Over time, this reasoning has elevated these tools, disclosure and transparency, to ends in themselves, despite the flaws in the Efficient Market Hypothesis.

Although the current paradigm is obsolete, a new paradigm has yet to take its place. As a result, regulators do not have effective guiding principles when engaging in rulemaking, leading to needless complexity and inefficiency. The author proposes a broad effort to explore the parameters of a new paradigm and provides several potential starting points for discussion and progress. The truisms of regulation, such as the value of transparency and disclosure, should be reconsidered—not necessarily abandoned, but examined to ensure that we are using them most effectively in support of our securities markets.

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THE current paradigm of securities market regulation in the United States is bankrupt. Regulators no longer have an effective overarching context for approaching regulation. Hence, the vast rulemaking mandated by the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[1] and the rulemaking urged after each new scandal is being approached on an essentially haphazard basis.[2] While the Dodd-Frank Act was born of the financial crisis, the failure of our current paradigm is a crisis of a more fundamental nature. What is needed is a broad effort to explore the parameters of a new paradigm that can provide a solid structure for the maintenance of the world's most important financial markets.

I. THE REGULATORY PARADIGM

The Securities and Exchange Commission ("SEC") officially adopted the integrated disclosure system on February 24, 1982. The system focused on providing material information to the marketplace for publicly traded securities.[3] The theory underlying the system was that if material information

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1 Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

2 CFTC Commissioner Scott O'Malia described his experience at the CFTC as one of being in a "rush to implement all the rules," and that certain of the rules being implemented were either "unworkable or simply make no sense." Steven Lofchie, *CFTC Commissioner O'Malia Gets Frank on Dodd-Frank Regulatory Framework*, CENTER FOR FINANCIAL STABILITY (May 15, 2013), http://centerforfinancialstability.org/wp/?p=2224.

3 John G. Gillis, *Integrated Disclosure System*, FIN. ANALYSTS J., May-June 1982, at 18.

is regularly and promptly distributed to the market through periodic filings and corporate communications, the market will absorb the information and it will naturally be reflected in the price of securities.[4] The adoption of the integrated disclosure system was the final proof that the theory known as the Efficient Market Hypothesis (the "Hypothesis") had been fully assimilated by policy-makers and established as the over-arching paradigm of securities market regulation.

Although the original formulation of the Hypothesis has been credited to numerous economists, the theory reached widespread acceptance by the 1970s.[5] The core assumption of the Hypothesis is that market participants are rational actors, and the pricing of securities in the financial markets reflects an equilibrium of rational expectations. The Hypothesis assumes that the prices of securities move in response to information, and that the market as a whole is able to distinguish the true 'signal' from the 'noise' of the vast amounts of information disseminated about publicly listed securities.[6]

The Hypothesis as paradigm was further evidenced in the Supreme Court's *Basic v. Levinson* decision in 1988. The Court's opinion relied upon the "fraud-on-the-market" theory and permitted plaintiffs to advance claims if they could prove, in part, that an efficient market for the relevant goods or industry existed, thereby giving rise to a presumption of reliance on such efficiency.[7]

The regulatory principles of disclosure and transparency are fundamental to the Hypothesis and its paradigm, and these terms have been the watchwords of regulators ever since. The Hypothesis naturally leads to the conclusion that more disclosure is better and that transparent markets are "healthier" markets.[8]

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4 Proposed Comprehensive Revision to System for Registration of Securities Offerings, 45 Fed. Reg. 63, 693, 63, 698 (Sept. 25, 1980) (codified at 17 C.F.R. pts. 230, 239).

5 University of Chicago economist Eugene F. Fama is the most widely-credited proponent of the Hypothesis, with his *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); s*ee also* Robert Shiller, *From Efficient Markets Theory to Behavioral Finance*, 17 J. ECON. PERSPECTIVES 83 (2003).

6 *See, e.g.*, Fama, *supra* note 5.

7 485 U.S. 224, 243-47 (1988).

8 *See, e.g.*, Asset-Backed Securities Disclosure and Registration, Securities Act Release No. 33,9638, Exchange Act Release No. 34,72982, 79 Fed. Reg. 57,184, 57,194 (Sept. 4, 2014) ("We note that the rules are intended to increase transparency about the potential risks in the [asset-backed securities] market through greater loan-level disclosure . . . thus providing better tools for investors to evaluate their capital allocation decisions. These measures should lessen the risk of overreliance on credit ratings as investors will now be able to conduct their own due diligence using more transparent and fuller disclosures regarding the assets underlying a securitization. Disclosure of higher quality and more

Not long after the Hypothesis was accepted as the basis for securities regulation in the United States, social scientists and economists began to identify flaws in the theory. Research into human cognitive biases and the failure of actors to conduct themselves in accordance with expected utility models undermined commonly-held assumptions that we are generally rational actors.[9] By identifying that people rely heavily upon heuristics in their daily decision-making, and conducting experiments that identified biases, such as "Confirmation Bias," "Sampling Bias," and the "Overconfidence Effect," among many others, this research triggered a now well-assimilated change in the way we view our actions as a society.[10]

Economists, in turn, picked up on this research, and the field of behavioral finance was born. Researchers applied these concepts to the securities market and concluded that investors as a group are subject to waves of optimism and pessimism that can cause the prices of securities to deviate systematically from their fundamental values.[11] This indicated that public disclosure of relevant information about a security does not always lead to the market efficiently digesting the information and pricing securities appropriately. In fact, information is sometimes the catalyst for outsized market reactions.[12]

Proponents of the Hypothesis have continued to refine and revise the Hypothesis to attempt to account for the arguments of behavioral finance thinkers, but the fundamental principal—that the markets behave rationally, and thereby will efficiently determine prices—has been largely discredited.[13]

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complete data regarding the loan characteristics of the underlying collateral should result in better capital allocation decisions, improved capital formation and, ultimately, lower capital costs by making the markets more informationally-efficient.").

9 *E.g.*, Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979).

10 *See, e.g.*, Peter C. Wason, *On the Failure to Eliminate Hypotheses in a Conceptual Task*, 12 Q.J. EXPERIMENTAL PSYCHOL. 129 (1960); James J. Heckman, *Sample Selection Bias as a Specification Error*, 47 ECONOMETRICA 153 (1979); Nigel Harvey, *Confidence in Judgment*, 1 TRENDS IN COGNITIVE SCI. 78 (1997).

11 Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSPECTIVES 59, 60 (2003). *See also* Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, *in* 1B HANDBOOK OF THE ECONOMICS OF FINANCE 1051, 1054 (George M. Constantinides et. al. eds., 2003).

12 *See* Stavros B. Thomadakis, Are There Regulatory Implications to Behavioral Finance? (June 2008) (unpublished manuscript) (on file with the author) (arguing that our system relies upon sentimental investors, rather than rational investors, with only arbitrageurs serving as mediating forces).

13 *See, e.g.*, Robert J. Shiller, *The Sickness Beneath the Slump*, N.Y. TIMES, June 11, 2011, at BU6; Mark Buchanan, *What's Efficient About the Efficient Markets Hypothesis?*, PHYSICS OF FIN.

The *Basic* decision has continued to be questioned in subsequent cases, including in the *Amgen* case, where Justice Alito noted in his concurring opinion that *Basic* may rest upon a faulty economic premise.[14]

Most recently, in *Halliburton*, the Supreme Court declined to overrule *Basic*. The Court preserved a plaintiff's ability to invoke the "presumption that the price of a stock traded in an efficient market reflects all public, material information—including material misrepresentations."[15] The majority opinion notes that "[e]ven though the efficient capital markets hypothesis may have 'garnered substantial criticism since *Basic*,' . . . Halliburton has not identified the kind of fundamental shift in economic theory that could justify overruling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities."[16] The Court's opinion indicates a recognition that the Hypothesis may no longer be valid as an economic premise, but nevertheless asserts that overruling the *Basic* precedent would require a stronger general economic rejection of the validity of the Hypothesis. Putting it more bluntly in a concurring opinion, Justices Thomas, Scalia and Alito would have overruled *Basic*, stating that "[l]ogic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and *stare decisis* cannot prop up the façade that remains."[17]

Despite a broad academic rejection of the Hypothesis and the creeping legal rejection of the same, market regulation continues to revolve around efforts to improve transparency and disclosure.[18] The old paradigm of securities market regulation has been discredited, yet it remains and continues to guide regulation, while a new paradigm has yet to be identified. While this process of paradigmatic evolution unfolds, our regulators are effectively hamstrung without guiding principles. Until we can place regulation in a coherent theoretical framework, our laws and regulations will continue to fail in their essential mission. This is the true financial crisis, as without a vision

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(May 23, 2011, 2:01 PM), http://physicsoffinance.blogspot.com/2011/05/whats-efficient-in-efficient-markets.html.

14 Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1204 (2013) (J. Alito, concurring). Justice Alito noted that the case did not ask the court to invalidate the hypothesis; if it had, he hinted, he may have been favorably inclined to indulge such a request. *See also*, as cited by J. Alito, Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 175-76 (2009).

15 Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2402 (2014).

16 *Id.* at 2410 (internal citation omitted).

17 *Id.* at 2418 (Thomas, J., concurring).

18 *See, e.g.*, FINRA RULE 5123, FINRA MANUAL (Wolters Kluwer), at 6546-50; Proposed Comprehensive Revision to System for Registration of Securities Offerings, 45 Fed. Reg. 63,693, 63,698 (2014).

and framework for addressing the regulatory landscape, regulators and legislators are making decisions that will dramatically impact our markets for years to come without a coherent rationale.

II. THE STRUCTURE OF PARADIGMATIC CHANGE

T.S. Kuhn described paradigmatic change in his seminal work, the *Structure of Scientific Revolutions*. Analogizing paradigm change in the sciences to a revolution in thinking, Kuhn explained that "revolutions are inaugurated by a growing sense, often restricted to a segment of the [relevant] community, that an existing paradigm has ceased to function adequately in the exploration of an aspect of nature to which that paradigm had previously led the way."[19] This is precisely what has happened with the Hypothesis—its explanation of market behavior is no longer up to the task of guiding how we regulate our financial markets.

Discerning the contours of the paradigm in which we operate, particularly one that is still taking shape, is always exceedingly difficult. It took many years for the scientific community to recognize that Einstein had ushered in a new paradigm with the publication of his Special Theory of Relativity, as some continued to reject the fundamental notions it proposed.[20] However, the existence of a new paradigm doesn't mean that the former paradigm is no longer of value. As any casual observer of physics is aware, while we may be living in the age of quantum mechanics, Newtonian mechanics remains vital to our daily lives. What changed some time ago, however, is that Newtonian mechanics is not the guiding set of principles through which modern physics views the universe. Rather, Newtonian mechanics has a specific and relevant place within physics, though it is no longer the overarching paradigm within which physics operates.

Kuhn has pointed out that as it becomes apparent that normal science is incapable of adequately addressing significant anomalies in the system, we may discern the signs of the birth of a new paradigm. These signs include the proliferation of alternative versions of the principal theory and widespread

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19 THOMAS S. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS 91 (1962).

20 Although Einstein's seminal paper introducing special relativity, "On the Electrodynamics of Moving Bodies," was published in 1905 and Einstein was recommended for the Nobel Prize in 1912, objections and criticisms from notable contemporaries such as Philipp Lenard and Ludwik Silverstein persisted into 1920 and beyond. *See* Peter Havas, *The General-Relativistic Two-Body Problem and the Einstein-Silberstein Controversy*, *in* THE ATTRACTION OF GRAVITATION: NEW STUDIES IN THE HISTORY OF GENERAL RELATIVITY 88-125 (John Earman et al. eds., 1993).

expressions of discontent with the current regime.[21] While some have labored to prop up the underlying theory, through revisions of the Hypothesis,[22] it is fair to say that there are many signs that the current regulatory paradigm is failing.

A. Harbingers of the Failing Paradigm

Kuhn described the articulation and explanation of phenomena within the paradigm and the derivative theories that the paradigm supplies as "normal science."[23] One of the reasons, Kuhn explained, that normal science seems to progress rapidly is that its practitioners concentrate on problems that fit neatly within the predictive parameters of the paradigm. In the realm of the financial markets, this "normal science" work may be analogous to the continued extension of the principle of disclosure and transparency throughout the regulatory regime.

In fact, transparency has become such a leading idea in regulation, that it is cited without discussion as the final justification for many regulatory actions. There is little to no discussion of the value of transparency in a particular context or its relative costs in particular circumstances.[24] Rather, through the operation of the paradigm, transparency has been elevated to a virtue itself. Transparency as a foundational end in itself, however, is built on the quicksand of the Hypothesis. If markets are not necessarily efficient, then more information and disclosure are not necessarily helpful. Transparency, as seen in the light of current economic thinking, must be subjected to greater scrutiny to determine its true value to the marketplace in each particular situation.

Of course, that is not to say that disclosure and transparency should not be valued. Disclosure is an excellent disinfectant and can be beneficial to the

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21 KUHN, *supra* note 19, at 70-72.

22 *See, e.g.*, Malkiel, *supra* note 11, at 60. Malkiel argues essentially that even if the Efficient Market Hypothesis is vulnerable to criticism, markets are still "efficient" because investors cannot earn above-average risk adjusted returns. For example, Malkiel states "I will use as a definition of efficient financial markets that such markets do not allow investors to earn above-average returns without accepting above-average risks," and "whatever anomalous behavior of stock prices may exist, it does not create a portfolio trading opportunity that enables investors to earn extraordinary risk adjusted returns." *Id.*

23 KUHN, *supra* note 19, at 24.

24 *See* Joseph McLaughlin, *What's So Bad About Selective Disclosure?*, CORP., SEC. & ANTITRUST PRAC. GROUP NEWSL. (Federalist Soc'y, Washington, D.C.), Aug. 1, 1999.

markets.[25] But, disinfectants are not always the indicated cure. The increasing complexity and interconnectedness of contemporary financial markets has created new risks that cannot be addressed solely from the perspective of more and better disclosure and transparency.

B. Technology

At the time of the adoption of the integrated disclosure system in 1982, the average retail investor faced a tremendous disparity in information compared to her professional investor counterpart in the securities industry. The reports of public companies on which the system relied were available by mail from issuers themselves or in the reading room of the offices of the SEC. Sophisticated market participants, on the other hand, could subscribe to services that provided copies of these reports in as little as a few hours. Nonetheless, this information disparity was not deemed problematic by the SEC as the Hypothesis taught that the information would be priced into the market for the good of all investors.

The Internet has changed this situation dramatically, as all such information and much more is made available simultaneously to the investing public free of charge. Uniform, simultaneous disclosure has been achieved for most practical purposes, and has become an accepted part of the regulatory model.[26] Under the Hypothesis paradigm, this should have been one of the great end-goals of the system. Yet, no one is heralding the day.

Moreover, our financial markets have become increasingly automated and subject to technology's attendant risks. High-speed trading had previously been touted as a useful tool for providing liquidity and hastening the market to equilibrium – an amplification of the market forces envisioned in the

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25 Louis D. Brandeis, *Other People's Money*, HARPER'S WKLY., Dec. 20, 1913 ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."), *quoted in* Buckley v. Valeo, 424 U.S. 1, 67 (1976).

26 *See, e.g.*, Securities Offering Reform, Securities Act Release No. 33,8591, Exchange Act Release No. 34,52056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722, 44,783 (Aug. 3, 2005) (codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249, and 274) ("Many commenters and market participants have encouraged us to adopt an 'access equals delivery' model for final prospectus delivery. Under such an 'access equals delivery' model, investors are presumed to have access to the Internet, and issuers and intermediaries can satisfy their delivery requirements if the filings or documents are posted on a web site. The access concept is premised on the information or filings being readily available. At this time, we believe that Internet usage has increased sufficiently to allow us to adopt a final prospectus delivery model for issuers and their intermediaries that relies on timely access to filed information and documents.").

Hypothesis. But, the disclosure and transparency regulatory paradigm is of limited utility when high-speed trades go wrong.

For example, on May 6, 2010, automated trading of sell orders in a number of stocks caused a significant market disruption. Automated orders were triggered by a large sell order and created a cascade of additional orders. Liquidity in certain stocks was temporarily exhausted and wild fluctuations in prices resulted. At one point, the Dow Jones Industrial Average was down roughly 1,000 points before recovering to close down 348 points for the day, leading the day to later be dubbed the "Flash Crash."[27]

Another well-known trading glitch involved Knight Capital. On August 1, 2012, Knight went live with new software that had been improperly installed.[28] As a result, the firm executed buy orders in rapid succession, single-handedly inflating the prices of the securities it was buying. In less than 40 minutes Knight lost over $400 million and was nearly forced out of business.

The Flash Crash and the Knight Capital trading glitch catalyzed debates as to whether high-speed trading should somehow be reined in. Michael Lewis also recently published a book that describes what he considers abuses by high-speed traders.[29] However, none of these issues would have been prevented through increasing disclosure and transparency. The current paradigm does not provide us with a mechanism to rationally approach the problem. In fact, we do not even have the ability to assess whether high speed trading is the problem, or whether its impact on the market is merely a symptom of something else entirely. Perhaps the speed of trading that is available today merely exacerbates and exposes issues within our market's structure that have evolved as the paradigm faltered and haphazard regulations were applied.

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27 Ben Rooney, *Trading Program Sparked May 'Flash Crash'*, CNN MONEY (Oct. 1, 2010, 2:56 PM), http://money.cnn.com/2010/10/01/markets/SEC_CFTC_flash_crash/index.htm; *see also* STAFFS OF THE CFTC & SEC, FINDINGS REGARDING THE MARKET EVENTS OF MAY 6, 2010 (2010), *available at* http://www.sec.gov/news/studies/2010/marketevents-report.pdf.

28 John McCrank, *Knight Capital Posts $389.9 Million Loss on Trading Glitch*, REUTERS (Oct. 17, 2012, 7:18 AM), http://www.reuters.com/article/2012/10/17/us-knightcapital-results-idUSBRE89G0HI20121017; Nathaniel Popper, *Knight Capital Says Trading Glitch Cost It $440 Million*, N.Y. TIMES DEALBOOK (Aug. 2, 2012, 9:07 AM), http://dealbook.nytimes.com/2012/08/02/knight-capital-says-trading-mishap-cost-it-440-million.

29 MICHAEL LEWIS, FLASH BOYS (2014).

C. Complexity

Additionally, the ever-increasing complexity of financial products and hedging practices is growing beyond the ability of the market to account for them. For example, as chronicled in various financial crisis reports, while some savvy traders understood the issues leading to the collapse of the credit markets in 2008, the market as a whole clearly did not fully comprehend and price in appropriate risk premiums to many products.[30] Despite comprehensive information in the marketplace about specific securities and credits, the market appears to have been unable to fully comprehend and correlate all the various risks of the vast number of interrelated financial instruments.[31]

Of course, there are limits to our ability, as individuals, to understand complexity. So, it makes sense that there might be a limit to the complexity the market can understand. But, that limitation is antithetical to the disclosure/transparency paradigm, and the available tools in the regulatory tool kit do not seem to be able to fully address this limitation. For example, attempts at paradigm fixes, such as attempts to make prospectus language more comprehensible through "plain English" mandates have only helped on the margins.[32] Despite this, regulators continue to call for more disclosure,[33]

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30 *E.g.*, ANDREW ROSS SORKIN, TOO BIG TO FAIL (2009).

31 Furthermore, it may even be *rational* for market participants to invest in high-yielding complex securities without fully understanding them. As argued by Steven Schwarcz, the dispersion of risk creates 'anticommons' problems where no individual parties are sufficiently incentivized to understand the securities they are trading. Such risk-taking among investing firms was generally rewarded—until the bottom fell out. Steven L. Schwarcz, *Controlling Financial Chaos: The Power and Limits of Law*, 2012 WIS. L. REV. 815, 823-24 (2012). Conversely, a familiar suggestion aimed at eliminating such 'anticommons' problems generally, or forcing banks to grapple with complexity more directly, is to eliminate, by law, the possibility of bailouts. *See, e.g.*, Anil K. Kashyap, Lessons from the Financial Crisis for Risk Management 15, 18 (Feb. 27, 2010) (unpublished manuscript) (available at http://faculty.chicagobooth.edu/anil.kashyap/research/papers/lesson_for_fcic.pdf).

32 *See*, *e.g.*, Charles A. Jaffe, *Plain English No Substitute for Knowledge*, CHI. TRIB., Mar. 31, 1997, http://articles.chicagotribune.com/1997-03-31/business/9703310069_1_12b-1-investment-firms-sec ("The SEC's plain English initiative amounts to tinkering at the margins, but never tackles the problem of concepts and jargon that, like a 12b-1 fee, are neither plain nor English. . . . The [SEC Plain English Handbook] boils down to two words: good editing. It is a reminder to investment firms that 'if' is preferable to 'in the event of.'"). *See also* AFG, *Response to Committee of European Securities Regulators Consultation Paper: "A Guide to Clear Language and Layout for the Key Investor Information Document"*, ESMA (Sept. 10, 2010), http://www.esma.europa.eu/system/files/Div_2760_AFG_Response_to_CESR_Consultation_on_a_guide_to_clear_language_and_layout_for_the_KIID.pdf ("'[P]lain language'

though some have raised the question of whether investors are already drowning in information they do not understand or do not use.[34]

Moreover, effectively regulating human ingenuity and increased complexity is fraught with challenges. What seems clear is that we do not currently have a rational and meaningful way under the current regulatory paradigm to approach these issues. Rather, legislation and regulation have tended to be reactive to the various crises in the markets.[35]

D. Alternative Investments

Issuers have increasingly accessed the private side of the capital markets to avoid the lengthy and expensive process of registering their offerings with the SEC. In fact, the private market for securities transactions now surpasses the public market in overall size.[36] The significant growth of the private market in the United States may signal that investors do not value the transparency of the public markets (or at least the level of disclosure and transparency) to the extent assumed necessary by the regulators. Given the economic costs of the extensive public regime, it further calls into question the utility of the fundamental precepts of the current paradigm. Meanwhile, regulators press for more transparency in the private market, while essentially

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is not sufficient to help investors understand the information contained in the KIID. Some technical vocabulary cannot be avoided and from this perspective a pan European glossary is urgently needed in order for retail investors to be able to understand such technical words.").

33 The SEC's Investor Advisory Committee has called for additional disclosures by brokers, similar to the disclosure provided by investment advisers. *See* U.S. SEC. AND EXCHANGE COMM'N, *Recommendation of the Investor Advisory Committee: Broker-Dealer Fiduciary Duty*, SEC 6, 9 (Nov. 2013), http://www.sec.gov/spotlight/investor-advisory-committee-2012/fiduciary-duty-recommendation-2013.pdf.

34 Chair Mary Jo White stated in a recent speech that she is "raising the question here and internally at the SEC as to whether investors need and are optimally served by the detailed and lengthy disclosures . . . that companies are required to prepare and file with us. When disclosure gets to be 'too much' or strays from its core purpose, it could lead to what some have called 'information overload'—a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant." Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, Speech to the National Association of Corporate Directors Leadership Conference 2013: The Path Forward on Disclosure (Oct. 15, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370539878806#.VPDM5bPF8bg.

35 John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 818 (2011).

36 *See* Daniel Gorfine & Ben Miller, Op-Ed., *Who Needs Wall Street?*, WALL ST. J., Feb. 4, 2013, http://www.wsj.com/articles/SB10001424127887324081704578237412795346262.

ignoring the question of whether such additional requirements are properly addressing a real need.[37] If a consistently growing number of sophisticated investors are content to do business with the current level of protections, is there really a need for more? In fact, should the regulators really be worrying about protecting sophisticated investors, such as hedge funds, who frequently have greater resources than their counterparts in the market? Is that an appropriate role for regulation and the use of government resources?[38]

III. THE FRACTURED REGULATORY LANDSCAPE REFLECTS A BROKEN PARADIGM

The U.S. financial system is regulated by a fractured array of governmental and quasi-governmental bodies, which continue to proliferate. These regulators can be divided into essentially two groups: the prudential regulators, who focus primarily on the traditional banking industry, and the prescriptive regulators, who focus on the trading markets. The Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency are among the prudential regulators. These regulators favor direct involvement with the institutions they oversee to ensure that key principles are promoted, such as safety and soundness of the institutions.[39] The prescriptive regulators, including the SEC, the CFTC, FINRA and most state regulators, rely upon a vast number of individual rules to guide market participants subject to their oversight, with periodic examination and enforcement actions to ensure compliance.[40]

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37 *See, e.g.*, FINRA R. 5123, FINRA MANUAL (Wolters Kluwer), at 6531-6, 6531-7; FINRA Regulatory Notice 12-40, *SEC Approves New FINRA Rule 5123 Regarding Private Placements of Securities* 1-2 (Sept. 2012), *available at* https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p163707.pdf.

38 *See* William H. Donaldson, Chair, U.S. Sec. & Exch. Comm'n, speaking before the U.S. Senate Committee Hearing on Banking, Housing, & Urban Affairs: Testimony Concerning Investor Protection and the Regulation of Hedge Funds Advisers (July 15, 2004), *available at* http://www.sec.gov/news/testimony/ts071504whd.htm ("While some critics maintain that hedge fund investors do not need the protection of the Commission, the SEC's mission is to protect *all investors, large and small.* Rather than question whether hedge fund investors deserve the SEC's protection, it seems more appropriate to determine the most effective means of providing hedge fund investors with the SEC's protection.") (emphasis in original).

39 7 U.S.C. § 1a (39) (2012). Such regulators, which are statutorily defined to include the three agencies named above, in addition to the Farm Credit Administration and Federal Housing Finance Agency, are defined as "prudential" by law.

40 *See* Annette L. Nazareth, Commissioner, U.S. Sec. & Exch. Comm'n, Remarks Before the SIFMA Compliance and Legal Conference (Mar. 26, 2007), *available at*

While this fractured model has been in place for many years, the growing interconnectedness of these various markets has made regulating from separate silos more and more untenable. In fact, this very interconnectedness was at the heart of the recent financial crisis where financial instruments spanned different regulatory regimes. Congress intended the Dodd-Frank Act to address what were seen as the components of the various systemic problems, but the Act instead bolstered this fractured model. The Act provided on the one hand extremely prescriptive laws,[41] and on the other the "macroprudential" Financial Stability Oversight Council.[42] Efforts to consolidate regulatory authorities or move oversight of the trading markets in a more prudential direction have largely been unsuccessful. While there was some discussion of consolidation of various regulatory agencies in the wake of the financial crisis to more comprehensively address the issues of large financial institutions engaged in many different financial markets, turf battles quickly erupted and snuffed out all such talk.[43]

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http://www.sec.gov/news/speech/2007/spch032607aln.htm ("Since the beginning of time (which in the SEC calendar means 1934), the SEC has operated as a rules-based regulator as opposed to a prudential regulator.").

41 *See, e.g.*, the rules governing municipal advisors, which caused great confusion and uncertainty in the financial markets for several years. *See* Latham & Watkins LLP, *Client Alert: The Municipal Advisor Minefield*, LATHAM & WATKINS LLP (Feb. 8, 2011), *available at* http://www.lw.com/upload/pubContent/_pdf/pub3972_1.pdf; Latham & Watkins LLP, *Client Alert: The Final Municipal Advisor Rule: Navigating the Minefield*, LATHAM & WATKINS LLP (Nov. 22, 2013), *available at* http://www.lexology.com/library/detail.aspx?g=67b15f3a-e6ec-4ce3-9c74-452f468bb89a.

42 Federal Reserve Chairman Ben Bernanke described his desire that the fledgling FSOC, which is sited within the Treasury Department, pursue "[t]he analysis of risks from a systemic perspective, not just from the perspective of an individual firm, [an approach that] is the hallmark of macroprudential regulation and supervision." Ben S. Bernanke, Chair, Fed. Reserve Bd., Remarks Before the 47th Annual Conference on Bank Structure and Competition: Implementing a Macroprodential Approach to Supervision and Regulation (May 5, 2011), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20110505a.htm.

43 *See* Paul A. Volcker, Remarks to the Economic Club of New York: Central Banking at a Crossroad (May 29, 2013), *available at* http://blacksummitfg.com/wp-content/uploads/2013/06/NSLTR_May_Jun_2013.pdf ("The simple fact is the United States doesn't need six financial regulatory agencies. It is a recipe for indecision, neglect and stalemate, adding up to ineffectiveness. . . . The time has come for change. As things stand today, I am told that can't happen and it won't happen. However powerful the arguments for action, the vested interests—within the agencies, in the Congress and outside—are just too strong.").

Interestingly, a strong enforcement effort appears to be an important part of the prescriptive model.[44] The Dodd-Frank Act handed new enforcement powers to the CFTC, and Mary Jo White, Chair of the SEC, has promised greater and more effective enforcement.[45] Former SEC Chairman, Harvey Pitt, a vocal critic of prescriptive regulation, said, "[t]he SEC should shuck its erroneous view that it is an enforcement agency with regulatory powers and start acting like a regulatory agency that also has enforcement powers. ... By the time the SEC brings an enforcement action, the damage usually already has occurred."[46] Pitt envisions a more collaborative relationship between regulators and regulated entities, much like the relationship between the Federal Reserve and the banks it oversees.[47] In the prudential model, enforcement action appears less fundamental to the efficacy of the system. Regulator and regulated regularly communicate to demarcate the boundaries of permissible conduct, thereby preempting and rendering unnecessary much enforcement action.

Again, the fractured nature of this landscape points to the absence of a coherent paradigm. Agency regulation and legislative efforts of recent years have created a byzantine patchwork that was either reactionary, or at best, tactical without an overarching strategic vision. Certainly there is evidence of widespread discontent with the current system.[48] Surely, a new paradigm is needed (though that is far easier said than done).

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44 *See, e.g.*, Chris Brummer & Daniel Gorfine, *FinTech: Building a 21st-Century Regulator's Toolkit*, MILKEN INST. CTR. FIN. MKTS 10 (Oct. 2014), http://assets1c.milkeninstitute.org/assets/Publication/Viewpoint/PDF/FinTech-RegToolkit-Final-10-21-2014pm.pdf.

45 *Division Summary: Enforcement*, COMMODITIES FUTURES TRADING COMM'N, http://www.cftc.gov/reports/presbudget/2013/2013presidentsbudget0805.html ("The Dodd-Frank Act significantly enhances and expands the [SEC]'s powers and responsibilities and will, certainly by FY 2013 if not much sooner, result in a substantial increase in our workload.").

46 Harvey L. Pitt, *Bringing Financial Services Regulation into the Twenty-First Century*, 25 YALE J. ON REG., 315, 323 (2008).

47 *Id.* ("It is more effective to induce compliance with the law in the first instance than to utilize the club of enforcement after the fact to punish those who have violated the law. One way to achieve compliance is to include those subject to regulation in the regulatory process, by encouraging them to ask questions and vet proposed products, services, and activities in advance of implementation, rather than leaving market participants to guess at the legality of their plans and prosecuting them if they guess wrong.").

48 *See, e.g.*, *Volcker Says the "Financial System is Broken"*, N.Y. TIMES DEALBOOK (Sept. 24, 2010, 8:41 AM), http://dealbook.nytimes.com/2010/09/24/volcker-financial-system-is-broken/; Gretchen Morgenson, *After a Financial Flood, Pipes are Still Broken*, N. Y. TIMES, Sept. 14, 2013, at BU1.

IV. So, Now What?

> My propositions serve as elucidations in the following way: anyone who understands me eventually recognizes them as nonsensical, when he has used them—as steps—to climb beyond them. (He must, so to speak, throw away the ladder after he has climbed up it.) He must transcend these propositions, and then he will see the world aright.[49]

Here, Wittgenstein could be talking about establishing a new paradigm where, once established, the old precepts no longer make sense or are not seen in the same way. A new paradigm provides a new lens to look through, with a different focal length and different color refraction: through this perspective, we see things entirely differently. The challenge for us now is to figure out what sort of foundational precepts are emerging, and to try to establish some of the basic structures of the new paradigm for securities market regulation.

A. Assessing the Goals of Regulation

The mission statement of the SEC sets forth three essential goals: the protection of investors, the maintenance and facilitation of fair, efficient markets and the facilitation of capital formation.[50] Facially, these are laudable goals by almost any standard. Yet, these goals alone may be too simplistic to form a foundation for today's markets. For example, what should be done when these goals conflict? How far should investor protection be taken at the expense of the capital raising function of the markets? And, which investors should be protected—all or just some? To what extent and at what cost?

Perhaps the question of how to approach accomplishing these goals is more important. Overarching paradigms in science have generally been based on a set of axioms. These axioms form the foundation and superstructure of the paradigm from which the rest of the theory is built. Could the goals of the SEC act as principal axioms? In any event, we will not be certain of our new securities market paradigm until after it has been firmly established. But,

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49 LUDWIG WITTGENSTEIN, TRACTATUS LOGICO-PHILOSOPHICUS § 6.54, at 151 (D.F. Pears & B.F. McGuinness trans., 1961).

50 *What We Do*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/whatwedo.shtml (last visited Feb. 16, 2014).

we may be successful in hastening that day if we actively test different possibilities and consider different approaches.

B. Some Possibilities to Consider

Summarized below are a few approaches that fall far short of elucidating a new paradigm, yet might be useful in taking a fresh approach to the familiar landscape. In fact, inchoate ideas innately may pique our collective imagination and stimulate new channels of thought. Thus, in reviewing these pages, withhold judgment, and rather consider whether the ideas may lead you to think about the issues confronting the securities markets in some new ways. Essentially, these suggestions are presented as possible rungs on Wittgenstein's ladder to the next paradigm.

Dual Track Regulation. Instead of attempting to level the playing field for all investors, consider the creation of two distinct playing fields, each leveled for its participants. This is not a new idea, but rather one that has fallen out of favor. The idea has been around since at least the 1950s. The Supreme Court, in *SEC v. Ralston Purina Co.*, discussed the applicability of the private placement exemption from the registration requirements of the Securities Act of 1933 by stating that "[t]he natural way to interpret the private offering exemption is in light of the statutory purpose. . . . The applicability of § 4(1) should turn on whether the particular class of persons affected needs the protection of the Act. An offering *to those who are shown to be able to fend for themselves* is a transaction 'not involving any public offering.'"[51]

While many market regulations reflect a recognition of the differences between the retail market and the institutional market, there is a continuing movement by regulators to apply retail market principles to the institutional markets.[52] This practice is antithetical to the position taken by the Court in *Ralston Purina*, yet there is little explanation for this shift. As noted above, regulators have taken the position that even very sophisticated institutional investors require the protection of the securities laws, despite the fact that these sophisticated institutions often have more resources than their market

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51 SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953) (emphasis added).

52 For example, the application of the suitability rule to institutions. *See* FINRA RULE 2111, FINRA MANUAL (Wolters Kluwer), at 4113-14; FINRA Regulatory Notice 11-02, *SEC Approves Consolidated FINRA Rules Governing Know-Your-Customer and Suitability Obligations* 4-5 (Jan. 2011), *available at* https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf.

counterparties.[53] This is a point worth evaluating critically due to the enormous costs imposed on our system by the retail-*ization* of our markets. Perhaps a reasonable point of demarcation could be found at some level of sophistication and financial wherewithal at which the devotion of significant regulatory resources would no longer be necessary. That is, certain market participants would be permitted to play on a separate field where caveat emptor would be the fundamental assumption and the participants would succeed or fail based on their contractual duties and obligations.

An early advocate of this concept was SEC Commissioner Al Sommer, who expressed support for a system of "differential disclosure . . . by which the disclosure process can become more useful to investors and their advisors."[54] Sommer envisioned a disclosure system that distinguishes between financial professionals and unsophisticated investors as distinct audiences. The benefits of such a system could include both more simplified disclosure appropriate for a layperson audience, and more complex disclosure (e.g., projections, targeted returns, etc.) appropriate for sophisticated investors. Under this approach, "it would be possible . . . to perhaps mandate new kinds of mathematical and economic disclosure, including sophisticated projections and other forward looking information, which would mystify the average investor but make sense to the trained analyst familiar with sophisticated research methodology. Certainly an express abandonment of the small investor would open the door for far more sophisticated disclosure techniques."[55]

Intensive Prudential Regulation. One commentator suggests we model securities market regulation after the Nuclear Regulatory Commission's regulation of nuclear power plants.[56] This would take the form of continuous oversight, similar to that of the prudential regulators, but could be (arguably) more intensive.[57] The underlying theory here is that almost no level of failure of a nuclear power plant can be tolerated—they are, quite literally, too

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53 *See* Donaldson, *supra* note 38.

54 A. A. Sommer, Jr., Commissioner, U.S. Sec. & Exch. Comm'n, An Address for the Emanual Saxe Distinguished Accounting Lectures: Differential Disclosure: To Each His Own 27 (Mar. 19, 1974), *available at* http://www.sec.gov/news/speech/1974/031974sommer.pdf.

55 *Id.* at 14.

56 David L. Kornblau, *Regulate U.S. Markets Like the Nuclear Industry*, BLOOMBERG BUSINESS (Nov. 25, 2012, 6:30 PM), http://www.bloomberg.com/news/articles/2012-11-25/regulate-u-s-markets-like-the-nuclear-industry.

57 The Federal Reserve Bank even maintains staff in-house at some of the largest banks. *See Supervision and Regulation*, FED. RESERVE BANK N.Y., http://www.newyorkfed.org/aboutthefed/whatwedo.html (last visited Feb. 14, 2014).

dangerous to fail. Thus, enforcement after the fact is of little to no utility: prevention is the only acceptable alternative. Accordingly, this method relies on virtually continual communication and direct oversight rather than selective examinations and enforcement actions. Of course, this approach may not be practically feasible given the vast numbers of regulated participants in the securities markets and the resource constraints of the SEC and FINRA. However, absent the cost/benefit analysis, if the goal is simply to avoid crises in the same manner as those that the Nuclear Regulatory seeks to avoid, there may not be a better system.

The Trust Model. Charlie Munger, Vice Chairman of Berkshire Hathaway, expressed his company's approach to corporate governance by stating: hire people you trust and let them do their job.[58] Though it does not sound like a typical regulatory approach, the idea is being taken seriously in the corporate governance context. A recent paper found that business relationships based on trust can be more productive than those based on contract.[59] Of course, contract law theory has long considered these sorts of issues.[60] These lessons teach that not only is it impossible to anticipate all possible behavior to be avoided by contract, but strict enforcement of its terms emphasizes minimum standards of behavior. That is, the contract tends to "reduce, rather than increase, productive effort."[61] In addition, an environment based more on trust rather than contract is less costly, as it is more predictable.

> From an economic perspective, a "risk premium" is required to deal with uncertain behavior. Supervisors must put additional effort into monitoring employee actions, and employees must exert additional effort to demonstrate that they are compliant with the firm's standards. When trust is introduced into the environment, the motivations of each party are known ("certain"), their behaviors are predictable, and the "risk premium" is eliminated."[62]

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58 Andrew Ross Sorkin, *Berkshire's Radical Strategy: Trust*, N.Y. TIMES DEALBOOK (May 5, 2014, 9:18 PM), http://dealbook.nytimes.com/2014/05/05/berkshires-radical-strategy-trust/?_r=0.

59 David F. Larcker & Brian Tayan, *Trust: The Unwritten Contract in Corporate Governance*, STANFORD CLOSER LOOK SERIES 1, July 31, 2013, *available at* http://www.gsb.stanford.edu/faculty-research/publications/trust-unwritten-contract-corporate-governance.

60 *E.g.*, George Baker, Robert Gibbons & Kevin J. Murphy, *Relational Contracts and the Theory of the Firm*, 117 Q.J. ECON. 39 (2002).

61 Larcker & Tayan, *supra* note 59, at 1.

62 *Id.* at 1-2.

The nature of the prescriptive model of regulation is akin to attempting to contractually regulate the behavior of employees, which is by nature impossible, and leads to a never-ending cycle of more regulation as new behaviors are discovered that must be restricted in some manner. The prescriptive model tends to lead to distrust between the regulator and the regulated, as the regulated explore the parameters of regulation that the regulator then reviews post hoc, enabling the regulator to play "gotcha."[63]

In practice, the prudential model appears to engender trust, as regular interactions between the individuals at the bank and on the regulatory team breed greater comfort and knowledge of the values and integrity of their counterparts. This leads to greater predictability of the other's actions and reactions in times of stress. In my personal experience, I have witnessed these relationships leading individuals to strive for a higher level of compliance at the regulated entity rather than merely minimal compliance. While this model may be more suited to a single corporate structure and depends greatly on the culture of the firm, it appears to be an important component of promoting exemplary behavior. Accordingly, I would hope that "trust" is a candidate for an important role in the new paradigm.

Incentive-Based Approaches. As noted, the prescriptive model of securities market regulation focuses almost exclusively on regulating bad behavior. And, while injecting more trust into the equation may help provide positive incentives for securities market participants, more work can be done to promote good behavior. In fact, industry participants are sometimes loathe to outwardly promote "best practices" out of concern that regulators might adopt them as the minimum standard, which would further restrict options to businesses unnecessarily. Instead, what if regulators provided positive incentives for successful compliance, rather than merely penalizing deficiencies?

The Volcker Rule[64] requires firms to consider multiple factors, including inventory control and risk mitigation, when determining certain employees' annual compensation,[65] which may have a positive impact on the role of

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63 *See, e.g.*, Letter from Sean Davy, Managing Dir., SIFMA Corporate Credits Mkts. Div., to Marcia E. Asquith, Senior Vice-President & Corporate Sec'y, FINRA 7 (Mar. 15, 2013), *available at* http://www.sifma.org/comment-letters/2013/sifma-submits-comments-to-finra-on-finra-s-markup-proposal.

64 12 U.S.C. § 1851 (2012).

65 To qualify for the underwriting exemption under the Volcker Rule, banking entities' compensation structures are subject to certain requirements. In discussing the compensation requirements under the Rule, the Final Rule Release states that "a compensation plan based purely on net profit and loss with no consideration for inventory control or risk undertaken to achieve those profits would not be consistent with

compliance and risk management at firms. But, this is still far from a direct incentive for good behavior. A direct incentive could permit greater latitude to firms that have shown exemplary compliance. For example, a regulator could permit greater net capital flexibility (e.g., permitting smaller haircuts for regulatory capital charges under Rule 15c3-1 under the Securities Exchange Act of 1934) for those firms that have consistently exceeded certain capital metrics. That sort of incentive, which can directly enhance the profitability of the firm, could have a significant impact on the culture of compliance at a firm, including with regard to how the legal and compliance staffs are viewed internally.

Engagement Models. Chris Brummer and Daniel Gorfine have discussed the importance of flexible regulatory approaches to the developing financial technology (or FinTech) space, which could be applied more broadly to the financial markets.[66] They emphasize "agile and iterative rulemaking"[67] that would permit the organic growth of disruptive technologies. "By engaging companies as they develop their business models, regulators can create a positive feedback loop with market participants that help both make wiser decisions."[68] The United Kingdom's Financial Conduct Authority's Project Innovate is an example of this approach. Other thinking in this area includes "Open Data and Algorithmic Regulation," in which Tim O'Reilly describes possible approaches to regulating big data.[69] In sum, these approaches seek to have the regulator directly engage with the industry in delineating the appropriate parameters for commercial activity. This is in stark contrast to the more removed and reactive, "regulation by enforcement" model that marks our current system.[70]

Open-Source Solutions. Perhaps a radical new approach to rulemaking would help discern the parameters of the emerging paradigm. Professor Clay Shirky has suggested that one path forward for democratic government could

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the underwriting exemption." Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationship with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5,535, 5,574 (Jan. 31, 2014) (codified at 12 C.F.R. pts. 44, 248, 351; 17 C.F.R. pt. 255).

66 Brummer & Gorfine, *supra* note 44, at 6-14.

67 *Id.* at 8.

68 *Id.* at 11.

69 Tim O'Reilly, *Open Data and Algorithmic Regulation*, BEYOND TRANSPARENCY (2013), http://beyondtransparency.org/chapters/part-5/open-data-and-algorithmic-regulation/.

70 Hester Peirce, *Obama Nominations Signal Regulation by Enforcement*, REAL CLEAR MARKETS (Jan. 30, 2013), http://www.realclearmarkets.com/articles/2013/01/30/obamas_nominations_signal_regulation_by_enforcement_100119.html.

be the pursuit of open-source legislation, borrowing from the development of computer code in open source programs, such as Linux. The idea would permit open collaboration between individuals who access legislative proposals that are being considered and who can directly make changes to the proposed laws.[71] Open source methodology gave rise to powerful software solutions, and such cooperation without active coordination, argues Shirky, facilitates the creation of enormous, complex communities. Given the complexity of the financial markets, this sort of approach could be helpful in harnessing the vast resources of market participants in addressing regulation.

Some efforts along these lines are already underway. One effort Shirky points to is the New York State Senate program, "Open Senate." The program allows the public to view and comment on bills and resolutions over the Internet while these bills are still in the proposal stage.[72] While federal administrative rules and regulations are subject to mandatory review and comment periods under the Administrative Procedure Act, such review is by nature limited and far less fluid than the process envisioned by Shirky.[73] Moreover, the congressional legislative process has no such review process. Perhaps opening up legislation to such direct democratic comment would facilitate more intelligent outcomes. Certainly, the ability of practitioners who daily wrestle with these issues on all sides of the marketplace to weigh in not only on general concepts but the specific language of rulemaking could be beneficial. Of course, managing the process to an appropriate end would be challenging (though it would likely be quite entertaining!). Nonetheless, such a process could help expose the fundamental tenets of the markets, as the crowd crafts legislation to address its needs.

Quirky Incorporated, a company that encourages and assists invention through crowdsourcing, uses a model that might be tuned to regulatory needs. In the Quirky model the community supplies the ideas. Quirky helps evaluate, refine and lead selected inventions through the development and

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71 TED, *Clay Shirky: How the Internet Will (One Day) Transform Government*, TED TALKS (June 2012), http://www.ted.com/talks/clay_shirky_how_the_internet_will_one_day_transform_government.html. For prior writing by Shirky on how the internet changes the way we form groups and exist within them, *see* CLAY SHIRKY, HERE COMES EVERYBODY: THE POWER OF ORGANIZING WITHOUT ORGANIZATIONS (2008).

72 *Open Senate*, N.Y. STATE SENATE, http://www.nysenate.gov/open (last visited Feb. 16, 2014); *see also* REGULATION ROOM, http://regulationroom.org (last visited Feb. 16, 2014), for a similar effort by Cornell University to foster wider democratic collaboration, whereby relevant public stakeholders are invited to comment on proposed rules and laws.

73 Pub. L. No. 79-404, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.).

manufacturing processes with the help of the crowd at key decision points. Putting the rulemaking initiative in the hands of the crowd rather than the regulator makes some sense, as we have seen regulator-driven initiatives sometimes fall flat when they are finally proposed after much internal labor.[74] Internal initiatives necessarily respond to internal and external politics, while crowd-sourced initiatives respond directly to perceived needs. Of course, these perceived needs may not always align with the mission of the regulator. But in this model, the regulator, with the assistance of the crowd, can pick and choose between them, and then guide and shape the process from there with appropriate input from the crowd at designated intervals.

CONCLUSION

Establishing the appropriate principles on which our system of securities market regulation should be built is an enormous, and vital, undertaking. Continuing to reactively regulate our markets could threaten the very strength of our markets and their standing in the world. All those who care about our securities markets should remain actively engaged in the question of what is the best way to regulate these markets. I suggest that this engagement involve the broadest possible array of approaches to the problems so as to elicit new solutions. Let us reconsider the truisms of regulation, such as the value of transparency and disclosure—not that we should abandon them—but rather, to ensure that we are using them most effectively in support of the markets and their purpose in American society.

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74 For a famous example of this, see the so-called "aircraft carrier" release. *See* SEC Release No. 33-7606, 34-40632, IC-23519 (November 3, 1998).