Washington University Law Review

Volume 89 | Issue 2

2011

Market Makers and Vampire Squid: Regulating Securities Markets After the Financial Meltdown

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MARKET MAKERS AND VAMPIRE SQUID: REGULATING SECURITIES MARKETS AFTER THE FINANCIAL MELTDOWN

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"The world's most powerful investment bank is a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money."

—Rolling Stone, July 2009.[1]

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Senator Collins: [W]hen you were working at Goldman, did you consider yourself to have a duty to act in the best interests of your clients?

Mr. Sparks: Senator, I had a duty to act in a very straightforward way, in a very open way with my clients. Technically, with respect to investment advice, we were a market maker in that regard. But with respect to being a prudent and a responsible participant in the market, we do have a duty to do that.

Senator Collins: OK. You are not really answering my question. I understand the difference between suitability standards, which you did have to follow, versus a fiduciary obligation to act in the best interests of your clients. I understand that you do not have a legal fiduciary obligation, but did the firm expect you to act in the best interests of your clients as opposed to acting in the best interests of the firm?

Mr. Sparks: Well, when I was at Goldman Sachs, clients are very important and were very important, and so—

Senator Collins: Could I—I am starting to share the Chairman's frustration already, and I am only 30 seconds into my time. Could you give me a yes or no to whether you considered yourself to have a duty to act in the best interest of your clients?

∗ Peter P. Weidenbruch Jr. Professor of Business Law, Georgetown University Law Center. I received helpful comments from Stanislav Dolgopolov and excellent research assistance from Brendan Sullivan.

1. Matt Taibbi, *The Great American Bubble Machine*, ROLLING STONE, July 9–23, 2009, at 52, 52.

Mr. Sparks: I believe we have a duty to serve our clients well.

—Senate Hearing, April 27, 2010.[2]

I. INTRODUCTION

The meltdown of America's investment banking industry in 2008 (disappearing into commercial banks via government-induced mergers or morphing into bank holding companies with access to the Federal Reserve's credit window) precipitated the federal bailout that created such angst in the American populace through the 2010 elections and beyond.[3] Senate hearings in April 2010 painted a picture of investment banks "funneling" for cash in ways that appeared to create fundamental conflicts with customers. Senator Carl Levin, for example, berated Goldman Sachs bankers for continuing to sell to customers securities that Goldman Sachs employees had vividly disparaged with barnyard epithets.[4]

In tone and impact the 2010 hearings echoed the Pecora hearings of 1933 that crystallized for Main Street a similar disconnect between bankers on Wall Street and their customers. The denouement of those hearings occurred in the final ten days of the Hoover administration and the dying days of a lame duck Congress.[5] Ferdinand Pecora, having been appointed as Chief Counsel to the Senate Committee on Banking and Currency only weeks before those hearings,[6] focused on a leading Wall Street icon, National City Bank, and its chief executive officer, Charles

2. *Wall Street and the Financial Crisis: The Role of Investment Banks: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 111th Cong. 26–27 (2010) [hereinafter *Hearing*].

3. Bear Stearns and Merrill Lynch were taken over by large commercial banks in March and September 2008, respectively, in deals pushed by the U.S. Treasury and the Federal Reserve Board. Lehman Brothers entered bankruptcy that September. The two remaining large investment banks, Goldman Sachs and Morgan Stanley, became bank holding companies at the end of the same week that Lehman went under, entitling them to obtain credit from the Federal Reserve at favorable rates. U.S. Treasury Secretary Henry Paulson first proposed a federal bailout the same week. *See* DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC 176–217 (2009). The bailout was initially defeated in the House of Representatives, but after a large stock market decline and continuing market unrest, it was passed by Congress and signed by President George W. Bush. *See id*. at 226–27. Various incumbents who lost election in 2010, both in the Republican primaries and the general election, were criticized for voting for this bailout. *See* Carl Hulse & David M. Herszenhorn, *Bank Bailout is Potent Issue for Fall Races,* N.Y. TIMES, July 11, 2010, at A1.

4. *Hearing*, *supra* note 2, at 25.

5. *See generally* MICHAEL PERINO, THE HELLHOUND OF WALL STREET: HOW FERDINAND PECORA'S INVESTIGATION OF THE GREAT CRASH FOREVER CHANGED AMERICAN FINANCE (2010) (detailing the Pecora hearings).

6. *Id.* at 52–59 (stating that several other prominent lawyers had declined the position).

Mitchell.[7] The hearings revealed a degree of executive compensation previously unknown to the American public, illusory stock transactions seemingly used to avoid income taxes on Mitchell's million dollar salary, and National City's securities arm selling securities to investors that the company itself was dumping.[8]

The Pecora hearings, like their 2010 counterpart, gave the final boost to financial reform legislation that passed the Senate within weeks and was on the President's desk within a hundred days.[9] The Securities Act of 1933 regulated the issuance of securities and cabined the influence investment banks previously had in that process.[10] The Glass-Steagall Act, passed in the same month, fenced off investment banks and their speculative activities from commercial banks.[11] In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act[12] ("Dodd-Frank") banned banks from the proprietary trading that seemed to have caused the worrisome activities discussed in the Senate hearings, set in motion a process to expand a broker-dealer's fiduciary duties to retail customers, shifted much of the troublesome derivatives trading onto exchanges and clearing houses, and provided for new capital regulation and resolution authority for the country's largest financial institutions.[13]

The defense of the investment bankers in the 2010 hearings was that they were simply making markets for buyers and sellers who could take care of themselves, so that conflict didn't really matter in that setting.[14]

7. *Id*. at 71–73.

8. *Id.* at 152–66.

9. The Pecora hearings began on February 21, 1933, and President Franklin Roosevelt signed the Securities Act on May 27, ninety-five days later. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 2 (3d ed. 2003) ("President Roosevelt, personally, would attribute to the Pecora hearings a decisive role in making possible the legislation of the First Hundred Days of his administration."). The Goldman Sachs hearings took place on April 27, 2010, and President Barack Obama signed Dodd-Frank on July 25, eighty-five days later. *See* DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 56 (2011) ("[T]he outrage at Goldman, which had already become an emblem of Wall Street hubris, gave the legislation irresistible momentum.").

10. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

11. Banking Act of 1933 (Glass-Steagall Act), Pub. L. No. 73-66, 48 Stat. 162 (repealed 1999).

12. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

13. *See* SKEEL, *supra* note 9, at 4–8 (discussing various provisions of the legislation).

14. For example, Senator Collins asked a panel of four then-current or former Goldman Sachs executives whether they believed that they had a duty to act in the best interest of their clients. Only one executive answered in the affirmative: "Not only do I believe that we do, I believe that we did"; the remaining three executives, including Mr. Sparks, gave variations of an answer regarding market making. *Hearing, supra* note 2, at 26–27.

Fabrice Tourre, one such banker who gained a measure of notoriety during the hearings, described this function as

> connecting clients who wished to take a long exposure to an asset—meaning they anticipated the value of the asset would rise—with clients who wished to take a short exposure to an asset—meaning they anticipated the value of the asset would fall. I was an intermediary between highly sophisticated professional investors—all of which were institutions.[15]

While the argument failed to deter Congress from including the Volcker Rule banning proprietary trading in the 2010 legislation, market making and conflicts between securities intermediaries and investors remain core issues at the heart of understanding and framing financial reform of the securities industry.[16]

Why did the Goldman Sachs executives cling to the mantle of market makers and continue to answer in ways that so frustrated Senator Collins as reflected in the excerpt at the beginning of this Article?[17] These men knew that the services the firm provides to investors come in two flavors. Sometimes clients come to them for advisory services (e.g., services relating to takeovers, raising money for the company, or portfolio investing). At other times, investors look to them as market makers, intermediaries with an inventory of securities that can be bought or sold in which the investment banker is on the opposite side of the transaction from the investor.

The executives also would have known that there is a core regulatory difference between the two relationships. In the first, there is an agency relationship—the intermediary is bound by law to be loyal to the client, putting the client's interests first.[18] In the second, the law has deferred to the marketplace and to the incentives and monitoring that goes with that; the law's contribution is little more than mumbling the ancient Latin admonition caveat emptor.[19] After the recent meltdown one recurring explanation was the desire (and the ability) of financial firms to pick their regulators.[20] Here we have an illustration of the bankers trying to put more

15. *Id.* at 17.

16. Financial reform remains a work in progress. In the areas discussed here, key rulemaking will not occur until late 2011 and 2012 with implementation occurring even later. *See infra* Part III.

17. *See supra* notes 2 and 14 and accompanying text.

18. *See infra* note 45 and accompanying text.

19. "Let the buyer beware."

20. *See, e.g.*, Chana Joffe-Walt, *Regulating AIG: Who Fell Asleep on the Job?*, NAT'L PUB. RADIO (June 5, 2009), http://www.npr.org/templates/story/story.php?storyId=104979546 (stating that

of their interaction with investors within the market regulation category and less in the legal regulation space.

The third thing these Goldman Sachs executives would have known is that the overwhelming majority of the firm's profits had come from trading for its own account as principal as opposed to providing advisory services or acting as an agent for its customers' securities transactions (traditionally the backbone of investment banking activities).[21] The securitization wave of the new finance swept in an increasingly wider array of products for which markets could be made (and principals could trade).[22] The explosion of derivatives spawned what seemed at times an infinite ability in the new financial world to create synthetic bundles of rights, barely linked to (or bounded by) the underlying activity of the real economy.[23]

Goldman Sachs knew that this trading-based paradigm provided increased areas of conflict with clients. Recent biographies of the firm trace a key theme visible through the leadership of Robert Rubin, Henry Paulson, and Lloyd Blankfein: a shared belief that the firm could manage this conflict and reap the benefits of this proprietary-based mode and, indeed, that it needed to do so to survive.[24] They were not alone; the rest of the investment banking industry was interested in the same thing.[25] Congress was not so sure. The Abacus transaction and similar deals that were the focus of the 2010 Senate hearings illustrated the particular

"national banks choose their regulators—they go shopping. . . . [R]egulators want to get picked, because banks pay them for the service of regulation.").

21. Michael Hiltzik, *Investment Banks Aren't Required to Act in Clients' Best Interest*, L.A. TIMES, May 16, 2010, at B1 (reporting that "[i]n 2001, Goldman Sachs reported pre-tax earnings of $719 million from investment banking (helping clients raise capital), $2.1 billion from providing brokerage services and $1.2 billion from trading. Last year, it reported $1.3 billion from investment banking, $1.3 billion from brokerage and $17.3 billion from trading.").

22. *See generally* GILLIAN TETT, FOOL'S GOLD: HOW THE BOLD DREAM OF A SMALL TRIBE AT J.P. MORGAN WAS CORRUPTED BY WALL STREET GREED AND UNLEASHED A CATASTROPHE 12 (2009) ("This new form of trade quickly spread across Wall Street and the City of London, mutating into wildly complex deals that seemed to give bankers godlike powers.").

23. *See generally* Margaret M. Blair, *Financial Innovation, Leverage, Bubbles and the Distribution of Income*, 30 REV. BANKING & FIN. L. 225 (2011) (describing the growth in the financial portion of the economy and the risks that have flowed from that).

24. WILLIAM D. COHAN, MONEY AND POWER: HOW GOLDMAN SACHS CAME TO RULE THE WORLD 444 (2011) (stating that "Goldman was constantly blurring the lines and more and more clients were getting angry"); CHARLES D. ELLIS, THE PARTNERSHIP: THE MAKING OF GOLDMAN SACHS 669 (rev. ed. 2009) (describing a Blankfein speech at an international financial conference in 2005 as embracing conflicts).

25. Charles Prince, then-CEO of Citicorp, put it this way: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Michiyo Nakamonto & David Wighon, *Bullish Citigroup is "Still Dancing" to the Beat of the Buy-out Boom*, FIN. TIMES, July 10, 2007, at 1.

concern that investment banks were betting against their clients, taking positions that would pay off if the housing market worsened while at the same time selling securities to clients who thought the housing market would continue its upward trajectory.[26]

Dodd-Frank reveals a conscious legislative effort to move more of the conduct of securities intermediaries from market-regulated space to law-regulated space. Under the Volcker Rule, banks (a group that now includes all of the largest American firms performing the traditional functions of investment banks[27]) are banned from proprietary trading in which they engage in transactions opposite their customers.[28] More broker-dealer interactions with investors are to be governed by fiduciary duty.[29] Yet both of these core principles need large asterisks next to them. The enhanced fiduciary duty will only attach once a lengthy study[30] and rulemaking occur[31] and even then will likely only apply to retail customers.[32] The ban on proprietary trading has two large exceptions that could easily encompass the same behavior that was a focus at the 2010 hearings (or at least how the investment banks described their behavior at the hearings).[33] The Federal Stability Oversight Council's initial study on proprietary trading describes the core challenge: the activities permitted by the two

26. *Hearing*, *supra* note 2, at 9 ("Goldman sold financial products that were tied to the health of the housing market, even while Goldman itself was betting that the housing market would collapse.").

27. *See supra* note 3.

28. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824–30 (2010).

29. *Id.*

30. §§ 913(b)–(c), 124 Stat. at 1824–27.

31. § 913(f), 124 Stat. at 1827–28.

32. § 913(g)(2), 124 Stat. at 1828 (amending section 211(g) of the Investment Advisers Act of 1940 to include a provision allowing the SEC to "promulgate rules to provide that the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide)"). Dodd-Frank defines a "retail customer" as a "natural person, or the legal representative of such natural person, who receives personalized investment advice about securities from a broker, dealer, or investment adviser; and uses such advice primarily for personal, family, or household purposes." § 913(a), 124 Stat. at 1824. In the lead-up to the legislation, there were arguments to apply an enhanced fiduciary duty to the broader group of investors. *See Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrant for Willful Violations?: Hearing on S. 3217 Before the Subcomm. on Crime and Drugs of the S. Comm. on the Judiciary*, 111th Cong. 109 (2010) (testimony of John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School) [hereinafter Coffee Testimony]. While the legislation does contain a parenthetical authorizing the SEC to also include "such other customers as the Commission may by rule provide," § 913(g)(2), 124 Stat. at 1828, the SEC staff has already recommended rulemaking limited to only retail customers. *See infra* notes 181–206 and accompanying text.

33. *See infra* Part III.

exceptions "evidence outwardly similar characteristics" to the banned category of "proprietary trading."[34]

This Article unpacks the various activities of the key intermediaries in securities markets and market makers in particular. The goal is a better understanding of the distinction between those intermediary behaviors that can be left to market incentives and constraints and those for which governmental regulation might be sought. Some intermediary behaviors should be regulated the same, even though they possess different core legal characteristics (e.g., brokers who buy stocks for retail clients as agents and receive a commission versus dealers who sell the same stock to the same investors as principals and retain the markup over the price at which they acquired the stock in the market).[35] Conversely, some intermediary transactions look the same but should be regulated differently (e.g., ordinary or "neutral" market-making transactions versus the same market-making transactions in which the dealer has additional incentives from related transactions that make it more interested in selling than buying). The result has been that, as in the 2010 hearings, market participants have been able to blur the line between those transactions for which market regulation will likely work just fine and those requiring governmental regulation. Part II presents the range of functions that intermediaries, such as investment banks, perform in contemporary securities markets. Part III provides an overview of economic incentives and constraints visible in such relationships and the key regulatory methods that have been employed when market control alone proves problematical: (1) requiring disclosure; (2) regulating conflict of interest; and (3) structuring markets.

Part IV draws on Parts II and III to suggest the regulatory approach that has the most potential for shaping the conduct of securities intermediaries. Legislation that has followed the meltdown reveals not just a move from market regulation towards more government regulation but towards a different kind of government regulation. In modern securities markets, a focus on disclosure by issuers alone has come up short. As was true in 1933, regulation of the behavior of securities intermediaries occupies a central focus that includes some measures aimed directly at conflict

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34. FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 18–22 (2011) [hereinafter FSOC STUDY], *available at* http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

35. *See infra* Part II.

transactions and other market structures designed to counter incentives that distort intermediary behavior.

It turns out that a focus on intermediaries who are dealing with other people's money and not their own is underinclusive as a trigger of governmental regulation, while a focus on leverage and speculation may be overinclusive. More relevant are the asymmetrical incentives of the market maker—a successful regulatory approach to the recent financial meltdown is likely to have more in common with, for example, the response to the analyst scandals of the previous decade.[36] High compensation can be a cause of concern;[37] where the compensation comes from and whether it destroys the market maker's indifference to which side of the transaction it is on are more relevant than simply the amount of compensation.

II. UNDERSTANDING INTERMEDIARIES IN MODERN SECURITIES MARKETS

Securities markets connect those in need of funds for a new idea or project with those willing to invest in the projects of others. When markets are performing this capital-raising function, the issuer of the securities (and the entity that will put the funds into production) is on one side of the transaction and investors occupy the other side. Alternatively, securities markets permit buyers and sellers to transact in existing securities. When markets host this trading function, investors are on both sides: the investor on the selling side needs money more than the security (or thinks the security is overvalued at its current trading price), and the investor on the buying side has money she is willing to invest (and believes the security is a good investment at its current trading price).

Sometimes these parties can find each other and conclude a transaction. More often, there are intermediaries whose business it is to connect them. This Article is about those intermediaries. Investment banking firms are broad umbrella business enterprises that usually encompass a variety of intermediary functions in securities. These include both traditional categories, such as brokers, dealers, underwriters, and investment

36. *See* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 1036–138 (6th ed. 2009) (describing the analyst scandals and reforms).

37. Floyd Norris, *Volcker Rule May Work, Even if Vague*, N.Y. TIMES, Jan. 21, 2011, at B1 ("If a trader is collecting millions in salary and bonus, you have to wonder whether he or she is merely trying to satisfy customer demand, as opposed to time markets.").

advisers,[38] and roles that have become more prominent in recent times, including prime brokers, basis swap counterparties, and protection buyers.[39] The economic functions of the various actors are overlapping and sometimes complex. Neither market participants nor regulators have rushed to clarify the categories.[40] This part, therefore, begins by offering two bookends to frame the space and the regulation and discusses the more complex roles of modern securities intermediaries against that framework.

A. Bookends to Frame Intermediaries

One end of the spectrum describing the different kinds of interactions a securities firm has with investors is when the firm provides advisory services related to transactions in which the intermediary is executing a trade for a client. It is the client's money that is being used, not the intermediary's. In common legal parlance, the intermediary is the agent, and the client is the principal.[41] Investment bankers advising clients about takeovers,[42] guiding a client in a leveraged buyout or other going private transaction,[43] or advising about portfolio investing fall within this category. Law generally provides rules of behavior to govern such relationships, particularly common law duties of agency.[44] For example, the duty of loyalty binds those who have control of other people's money

38. These categories are defined by the New Deal federal securities laws. Securities Act of 1933, 15 U.S.C. § 77b(a)(12) (2006) (defining "dealer" to include brokers); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(4) (2006) (defining "broker"); 15 U.S.C. § 78c(a)(5) (defining "dealer"); 15 U.S.C. § 78c(a)(20) (defining "investment adviser" and "underwriter"); 15 U.S.C. § 78c(a)(38) (defining "market maker").

39. These roles reflect market usage rather than statutory definitions. A prime broker, for example, provides a variety of services to firms like hedge funds including holding securities, lending funds for transfers, and helping the fund find transactions or investors. *See generally Prime Brokerage 101*, PRIMEBROKERAGEGUIDE.COM, http://primebrokerageguide.com/2009/03/prime-brokerage-101-introduction.html (last visited Dec. 11, 2011).

40. *See* Prohibition Against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 65,355, 76 Fed. Reg. 60,320, 60,325 (proposed Sept. 19, 2011) (to be codified at 17 C.F.R. pt. 230) (noting that the Securities Act does not define various terms used in the securitization context and stating preliminary belief that "terms such as placement agent and initial purchaser are sufficiently understood" in the securitization context).

41. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.").

42. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176–77 (Del. 1986) (discussing the role of Lazard Freres in advising Revlon how to resist a takeover).

43. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 706–07 (Del. 1983) (summarizing the role of Lehman Brothers in advising UOP, Inc. in a cash out by its majority shareholder).

44. *See supra* note 41.

in implementing securities transactions.[45] The Investment Advisers Act of 1940,[46] the last of the New Deal statutes passed to provide more social control over finance in the wake of the Great Depression, imposes fiduciary duties on investment advisers, including a duty to protect the best interest of their clients.[47]

At the other bookend defining intermediary relationship are firms acting as market makers. In this context, the investment bank interacts with investors as a dealer, putting the bank's own money on the line as a principal in the transaction and transacting with the investor as a counterparty. In their April 2010 Senate testimony, the Goldman Sachs executives tried very hard to place their activities at the market-maker end, where they acted as a dealer in turn with both buyers and sellers at prices that the counterparty in each transaction considered fair.[48] To visualize this end of the spectrum, consider a dealer or market maker from whom you buy a refrigerator, sofa, or used car. The dealer in such a setting invests money in inventory to have a selection to show you. The dealer will purchase its new products inventory from one or more manufacturers and its used products inventory from other consumers. In either event, the dealer's own money is on the line and the dealer must sell the product for more than it cost to acquire or else the dealer will not stay in business. The nature of a dealer's transaction is to trade opposite clients. Dealers typically do not disclose the identity of their prior or future buyers or sellers, or what the dealer paid to acquire inventory.

There are laws against fraud, but generally, the law leaves these transactions to be governed by the incentives and monitoring from the market. The ability of sophisticated investors to protect themselves will exceed the ability of the government to do so. Competitive markets mean that customers can go elsewhere if dealers do not provide the needed services. The incentives and monitoring in the market itself will police this behavior if there is sufficient information and if there are no barriers to

45. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. e (2006) ("As a general matter, the term 'fiduciary' signifies that an agent must act loyally in the principal's interest as well as on the principal's behalf.").

46. Pub. L. No. 76-768, 54 Stat. 847 (codified as amended in 15 U.S.C. §§ 80b-1 to 80b-21 (2006)).

47. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) ("[It is not] necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients." (footnotes omitted)).

48. *See, e.g.*, *Hearing*, *supra* note 2, at 17, 26–27.

contracting. If the transaction is not a "one off" purchase but a recurring series of transactions (in which the customer is a repeat player, and even more if the customer is transacting in bulk), the dealer will pay attention to what the purchaser needs and what different sellers have to offer. The dealer will need enough capital to invest in inventory to provide the appropriate selection to the customers. The customer looks to the dealer as a ready source of liquidity.

Market governance works best where information is observable and is not too costly.[49] In such a setting, the fact that the dealer's interest is opposite the investor's is not a concern—the parties can protect themselves by express contracting and choosing when to enter and exit market transactions. If the initial assumptions are relaxed—for example, information is not readily observable or is costly to obtain, or there are other reasons why the parties to the potential trade may not be able to trust the counterparty to take action to make the trade worthwhile—counterparties may discount the anticipated value to such a degree that the parties cannot find space for agreement.[50] Here the market maker may be able to provide a service in addition to the liquidity function described above by using its reputation to backstop risks about information or nonperformance, thereby enabling the parties to trade.[51]

Thus, a market maker will perform two different functions depending upon the universe of information and the risks of the counterparty not performing. In one, it will act little differently than how any other principal might act in trading as a counterparty if the setting is one where there is little worry if conflict exists. In the other, the intermediary is playing a richer role such that possible conflicts can trigger parties' reactions and possible government changes if private ordering does not provide sufficient checks to those conflicts.

B. Securities Dealers as Compared to Other Dealers

A dealer in securities does the same thing as dealers in other products—invests in an inventory of securities and seeks to make money

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49. *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 286–87 (1991) (discussing the role of information in mandatory disclosure).

50. *Id*.

51. *See* Steven M. Davidoff, Alan D. Morrison & William J. Wilhelm, Jr., *Computerization and the ABACUS: Reputation, Trust, and Fiduciary Duties in Investment Banking*, J. CORP. L. (forthcoming 2012), *available at* http://ssrn.com/abstract=1747647 (discussing these concepts in the context of investment banking).

on the spread.[52] Stock exchanges add an additional wrinkle because they frequently have required some specific obligations of dealers to commit in advance to making a market.[53]

Even in this simple dealer relationship in securities transactions, the actual interaction of intermediaries and their clients already blurs the bookend framework set out above. An investor who goes to a securities firm to acquire a particular security may just as easily end up in a broker transaction as a dealer transaction with no noticeable difference (and usually without any economic impact).[54] Thus, the firm may act as a broker or agent for the customer and acquire the security on the market, in which case the intermediary will receive a commission for its effort. If, however, the same investor goes to the same securities firm and the firm makes a market in that stock, the dealer as a principal sells the stock to the customer as purchaser and the dealer's compensation is the spread—the difference between what the dealer paid for the stock and what it sold it for on a round trip. In ordinary transactions the customer is indifferent as to whether the transaction occurred as a broker transaction or a dealer transaction—the customer gets the same securities at the same cost either way.

In this setting, the economic similarity of the two different relationships dominates the differences in legal form. The intermediary in both transactions is treated more like the dealer, with the reliance on market constraints rather than the fiduciary duty that applies to an ordinary

52. *See* ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS 454 (4th ed. 2006) ("A market maker is a dealer who stands ready to buy or sell a specific stock at quoted prices; the price at which a market maker is willing to sell (the asked or offered price) is, of course, somewhat higher than the price at which it is willing to buy (the bid price). The difference between the two quotes is called the spread and is the source of the market maker's profit." (emphasis omitted)).

53. The New York Stock Exchange, for example, historically assigned specialists for each stock with an obligation to step in as a counterparty when there were not enough of either buyers or sellers. *See generally* ROBERT A. SCHWARTZ & RETO FRANCIONI, EQUITY MARKETS IN ACTION: THE FUNDAMENTALS OF LIQUIDITY, MARKET STRUCTURE & TRADING 15 (2004). The NYSE has now shifted much of its trading to an electronic platform and has replaced specialists with designated market makers, whose obligations are considerably reduced. *See* Order Approving NYSE Proposed Rule Changes to Phase Out Specialists, Exchange Act Release No. 58,845, 73 Fed. Reg. 64,379 (Oct. 24, 2008). NASDAQ permits multiple market makers for a stock. Each market maker is required to post a minimum bid and ask for each stock (i.e., the price at which they will buy and sell), and they are required to be good for a minimum amount (e.g., a thousand shares). *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 14–15 (2d ed. 2008) (describing secondary securities markets more generally).

54. Rule 10b-10 requires a broker-dealer to provide written notice to customers disclosing whether it is acting as agent or principal and, if as principal, whether it is a market maker in the security. 17 C.F.R. § 240.10b-10(a)(2) (2010).

broker or agency status. But that is changing. An SEC study mandated by Dodd-Frank has produced staff recommendations that both brokers and dealers providing investment advice to retail customers should have the fiduciary duties of investment advisers.[55]

1. How Securities Dealers Are Different: Creating Inventory

Securities dealers are like dealers in other products in that they put up their own money to acquire inventory. They could confine themselves to acquiring inventory on the secondary market, but securities dealers often have a role in producing new inventory. Charles Mitchell, the CEO brought down by the Pecora hearings, compared his bank's securities function to the manufacture of other products[56]—but securities can be created without the large investment in physical assets necessary to produce those other assets. The inventory for a security transaction is a piece of paper creating a legal claim—an intangible asset where one's return requires valuing the worth of a common enterprise controlled by others.[57] That difference has long justified more regulation on production of securities than on production of other inventory.[58] For our purpose, the important practical difference is that the securities dealer is likely to have a role in the creation of the securities in a way that will transform its role from a neutral market maker to one with more to gain from selling than from buying. Where a market maker's function includes this reputation component and not just the liquidity function of express contracts,[59] there is added stress on private ordering that has supported legal regulation of conflicts of interest.

An investment banking firm that underwrites a new issuance of securities performs a dealer function, in that it purchases the entire offering of stock from the issuer and turns around and sells it to dealers in the selling syndicate who in turn sell the inventory to retail customers.[60] In this context, the underwriter's role is much more than an ordinary market

55. *See infra* Part IV.

56. PERINO, *supra* note 5, at 145 ("Mitchell explained to Pecora that City Bank did not just sell securities, it 'manufactured' them.").

57. SEC v. W.J. Howey Co., 328 U.S. 293, 297 (1946) (defining "investment contract" and "security" for purposes of federal securities law).

58. *See* COX ET AL., *supra* note 36, at 1 ("The securities laws exist because of the unique informational needs of investors. Unlike cars and other tangible products, securities are not inherently valuable.").

59. *See supra* note 51 and accompanying text.

60. *See* National Association of Securities Dealers, Inc., Exchange Act Release No. 17,371, 45 Fed. Reg. 83,707 (Dec. 12, 1980).

maker. The underwriter typically meets with the issuer, plans the offering, suggests the price at which it will be sold, and even advises the issuer about the organizational structure of the issuing company.[61] It has long been recognized that securities in an IPO are "sold, not bought."[62] When the issuer is a small company that is unknown to the market and the underwriter is a repeat player with a much larger reputation, it is the underwriter who does the heavy lifting.

The engine driving those sales is the spread, the difference between the price that the dealer (underwriter) acquired the stock from the issuer and the amount it receives when selling that same stock to the public. The difference between this round trip and the ordinary spread in secondary trading of securities is significant. Underwriters can still command 7 percent in an IPO,[63] while the spread on a round trip in the secondary or trading market has shrunk over the last two decades from $.25—as was common for large stocks on NASDAQ in the early 1990s—to less than a penny on the largest American traded stocks today.[64]

It was these incentives in the underwriting setting that propelled President Franklin Roosevelt to declare that caveat emptor and the incentives and monitoring of the market were no longer sufficient regulation for these dealer transactions.[65] The New Deal securities laws mandated that the dealers (including underwriters) must provide disclosure via complete prospectuses to their counterparty purchasers (something not required in a similar dealer transaction with a customer when the security

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61. *See* CHOI & PRITCHARD, *supra* note 53, at 418 (describing functions performed by underwriters).

62. Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979, 998 (1989) ("As they say on Wall Street, new issues are sold, not bought.").

63. *See* Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. FIN. 1105, 1110 (2000) (showing a move to more than 90 percent of IPOs with a 7 percent commission). Chen and Ritter's updated figure with data through 2008 shows the same result. Gross Spread for Moderate Size IPOs, 1980–2008, http://bear.warrington.ufl.edu/ritter/Gross%20Spread1980-2008.pdf (last visited Dec. 11, 2011).

64. Hendrik Bessembinder, *Trade Execution Costs and the Market Quality after Decimalization*, 38 J. FIN. & QUANTITATIVE ANALYSIS 747 (2003); Hendrik Bessembinder, *Trade Execution Costs on NASDAQ and the NYSE: A Post-Reform Comparison*, 34 J. FIN. & QUANTITATIVE ANALYSIS 387 (1999).

Comparing the spreads on the two transactions requires taking into account the dollar amount at which each transaction is sold. If a share of an IPO stock were to sell for $20, the underwriter's total spread would be 7 percent of that ($1.40); the spread for a dealer on the secondary markets would have been about one-sixth of that in the early 1990s and much less than that today.

65. H.R. REP. NO. 73-85, at 1–2 (1933) (message of President Franklin D. Roosevelt proposing the Securities Act) ("This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in security and thereby bring back public confidence.").

is traded on a secondary market).[66] The Securities Act of 1933 puts liability on the underwriters for failures in this disclosure regime.[67] Here the underwriter shares liability with the issuers and the issuers' directors and chief officers. However, the economic reality is that the underwriter often has the deepest pockets and becomes an attractive defendant for plaintiffs in this context.[68]

2. How Securities Dealers Are Different: Selling Both Sides

Securitization and synthetic swaps, at the heart of the recent crisis, suggest an archetypical dealer transaction with characteristics that seem to emphasize the two-sided nature of the dealer's function even more starkly than the traditional underwriter function in the issuance of a company's new securities. A market maker necessarily interacts with—and these dealers would say "sells" to—two parties: one party when acquiring the inventory and a different party when disposing of it. Both counterparties know that the dealer is trading opposite them in the transaction. In this setting, any party knows that the opposite side may well have the opposite belief about the value of the security—the buyer is taking the "long position," and the seller is taking the "short position."[69]

The swaps and similar synthetic securities prominent in the recent meltdown have formal characteristics that seem to make an even stronger case for a dealer transaction. Swaps often are structured as contracts in which the long position has to pay off if the value of the underlying security declines, while the short position has to pay off if the value of the security goes up.[70] A party knows that the counterparty has the opposite position and knows in a dealer transaction that that counterparty will be a dealer.

In off-exchange transactions, such as those involving many pre-crisis asset-backed securities and collateral debt obligations (CDOs), investment

66. Securities Act of 1933, Pub. L. No. 73-22, § 5, 48 Stat. 74, 77–78 (codified as amended at 15 U.S.C § 77e (2006)); § 10, 48 Stat. at 81 (codified as amended at 15 U.S.C § 77j).

67. 15 U.S.C. § 77k.

68. *See, e.g.*, COX ET AL., *supra* note 36, at 501.

69. *See* Prohibition Against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 65,355, 76 Fed. Reg. 60,320, 60,322 (proposed Sept. 19, 2011) (to be codified at 17 C.F.R. pt. 230) (describing long and short positions in a CDS transaction). Opinions on price do not motivate all trades. Traders may have liquidity needs or other reasons to buy or sell beyond price. Richard A. Booth, *The Uncertain Case for Regulating Program Trading*, 1994 COLUM. BUS. L. REV. 1, 65 (describing liquidity trading as "trading in response to portfolio decisions or extraneous needs for cash or trading that results from imbalances in supply and demand and not from inside information about fundamental value").

70. Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. at 60,322.

banks made markets in a setting where neither exchanges nor regulators provided any additional rules. Parties seeking to buy or sell such an instrument come to a particular dealer because they believe the dealer has expertise, can provide sufficient liquidity to buy or sell what the party needs, and can complete the trade.

In these off-exchange markets, the inventory comes from other parties who want to buy or sell, as it does on the exchanges. But what we saw in the frothy off-exchange markets for subprime mortgages and CDOs is that investment banks became deeply involved in creating new inventory. Instead of buying existing mortgage-backed securities on the market, an investment bank could create new securities. This can occur, for example, when new mortgages are obtained in exchange for money extended to property owners.[71] Securitization permits grouping multiple mortgages into packages and then slicing and dicing them to provide different levels of risk to investors with different risk preferences.[72] Synthetics replicate the economic risks of a securitized tranche without the need to create any new underlying mortgages.[73]

In such a setting, the dealer or market maker is no longer a neutral provider of inventory seeking to make money on the spread. Rather, like a traditional underwriter, the dealer becomes a producer of a synthetic inventory, selling incentives that will distort the neutral market maker function. When the market maker dealer responds to important customers who want more of a particular product that permits them to make money if the real estate market declines, the dealer's incentives to create more of those instruments become more distorted. The dealer may say it is simply providing what the buyers and sellers want, offering inventory and

71. A note, secured by a mortgage and held by an originating bank, is not necessarily a security in a commercial transaction in which the bank is not investing in an enterprise with profits depending on the efforts of others. *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946). The bank's sale of a participation interest to other institutional investors has provoked mixed views on whether it is a security. *Compare* Banco Espanol de Credito v. Security Pac. Nat. Bank, 973 F.2d 51 (2d Cir. 1992), *with Banco Espanol de Credito*, 973 F.2d at 56–60 (Oakes, J., dissenting). Sale of similar interests to unsophisticated investors has been held to be a security. *See* Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808 (2d Cir. 1994).

72. *See* Asset-Backed Securities, 75 Fed. Reg. 23,328, 23,329 (proposed Apr. 7, 2010) (to be codified at various parts of 17 C.F.R.) ("Securitization generally is a financing technique in which financial assets, in many cases illiquid, are pooled and converted into instruments that are offered and sold in the capital markets as securities.").

73. Abacus, a focus of the 2010 hearings, was such a synthetic. There was a reference portfolio of securities, but these securities were not traded. Rather, as their name suggests, they were simply the reference point for an exchange of promises depending on the default rate in the underlying reference portfolio. *See* Davidoff et al., *supra* note 51 (manuscript at 6–7 & n.37).

connecting purchasers and sellers,[74] but the asymmetrical incentives mean that it is making more of a return on the short side and using the "hard sell" tactics on the long side. Even more, the mantra that the dealer's economic function requires it to sell to both sides also permits it to sell its customers' securities that the company's employees would not buy for the company or themselves.[75] The effect is not that different from that described at the Pecora hearings in 1933. There, testimony revealed that National City Bank sold securities questioned by its own employees and then used the proceeds to exit the investment.[76] The prospect of banks making money on deals that cost clients money while executives raked in large salaries in times of financial distress motivated financial reform in both 1933 and 2010.

In the Goldman Sachs Abacus transaction that was a focus of the 2010 hearings, Paulson & Co. was an important hedge fund client for which Goldman provided prime brokerage services as an important source of continuing business.[77] Paulson believed the housing market was going down and wanted to purchase additional swap positions that paid if the market went down (while the counterparty would have the position that would pay off if the market went up).[78] There were not necessarily enough of these securities on the market, so Paulson's friendly investment banker set about creating new inventory to match the risk profile Paulson sought.[79] Goldman retained an independent firm to set up the CDO.[80]

The securities they chose were not just random collections of securities. Paulson was permitted to suggest securities to include in the package.[81] Unsurprisingly, Paulson preferred mortgages that were likely to

74. *See Hearing*, *supra* note 2, at 211–12 (prepared testimony of Fabrice Tourre).

75. *See id.* at 25 (describing internal Goldman Sachs email of July 1, 2007, in which Timberwolf, a $1 billion hybrid CDO Goldman had created, as a top-selling priority even though a June 22 email had described it as "one shi**y deal").

76. *See* PERINO, *supra* note 5, at 248–50 (describing securities offering of Brazilian bonds).

77. *See* COHAN, *supra* note 24, at 490 (describing how Paulson requested that "Goldman [] undertake individual trades of several hundred million dollars at a time").

78. *See* Complaint at 5, SEC v. Goldman, Sachs & Co., No. 10-CV-3229 (S.D.N.Y. Apr. 16, 2010) [hereinafter SEC Complaint], *available at* http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf ("Paulson developed an investment strategy based upon the belief that . . . certain mid-and-subprime [securities] . . . would experience credit events.").

79. *See* COHAN, *supra* note 24, at 509 (describing Paulson's request).

80. SEC Complaint, *supra* note 78, at 7 (Goldman Sachs "knew that identification of an experienced and independent third-party collateral manager as having selected the [reference] portfolio would facilitate the placement of the CDO liabilities in a market that was beginning to show signs of distress.").

81. *Id*. at 21 (alleging that Paulson played a "significant role" in the selection process).

run into trouble.[82] Paulson then bought the short side of these swaps, and investors bought the long side; however, investors were not told the package reflected the choices of the counterparty, who wanted the value of the package to go down.[83] The argument in response to criticism of such conduct was a variation of the "big boy" defense: the purchasers were sophisticated and knew what they were getting into so that when purchasers bought these swaps they knew the counterparty likely had the opposite view.[84]

Who would buy the other side of these swaps? There were still lots of folks in 2007 who thought that housing prices could never go down, but we also know from Michael Lewis's masterful book, *The Big Short*,[85] that the entities buying these positions were institutions whose managers were compensated for assets under management, not for how those assets performed.[86] Thus, investors did not seem able to see the risk of loss in their decision-making.[87] There is a telling scene in *The Big Short* when one of the main protagonists who forsaw the coming fall in real estate was seated next to one of these managers at a dinner in Las Vegas. From the dinner conversation, the trader came to realize how the manager's compensation incentives based on assets under management dominates everything else such that his firm would keep buying long positions.[88]

Such misaligned incentives on one side of the exchange when combined with the market maker's skewed incentives to the parties on the other side of the transaction mean there is no longer a neutral market maker. Goldman settled its action by paying a $550 million fine, without admitting or denying the allegations in the complaint, but it did

82. *See* COHAN, *supra* note 24, at 510 (noting that "the Paulson team had identified more than one hundred . . . securities that it thought could run into trouble, and they wanted the ABACUS deal to reference—or provide insurance on—these troubled bonds").

83. SEC Complaint, *supra* note 78, at 21 (alleging misrepresentations in disclosing selection of portfolio by agent "without disclosing the significant role in the portfolio selection processed played by Paulson [and] a hedge fund with financial interests in the transactions adverse to the counterparties").

84. *See* Zachary A. Goldfarb & Tomoeh Murakami Tse, *Goldman Says Its Clients Knew the Product*, WASH. POST, Apr. 21, 2010, at A12.

85. MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010).

86. *Id.* at 142–43.

87. *Id*. at 144 (relating manager's statement that he would rather have $50 billion in crappy CDOs than none at all, as he was paid on volume).

88. *Id.* at 142–43. This assuaged his concern that he should worry about doing the deal because the other side was out to get him.

acknowledge a "mistake" to reference the selection by the agent without disclosing Paulson's role and economic interest.[89]

The Magnetar transaction, profiled on National Public Radio's *This American Life* in 2010, suggested an even more worrisome arrangement.[90] In securitization, the assembler gathers a large number of mortgages or synthetic CDOs into one pool and then slices the package into tranches, selling the most secure tranches to one set of risk-averse investors and various more risky tranches to other sets of investors.[91] The bottom tranche—the part that would be paid last—was the riskiest and hardest to sell.[92] Those who believed that the housing market was going to tank wanted all of these investments to be available for them to take the short positions opposite the various tranches of investors.[93] To ensure this outcome, the short investors bought the long position on the most risky tranche.[94] They would get wiped out on that position, but it made possible all of the higher level tranches on which they could take short positions; it was still a net positive deal.[95] J.P. Morgan, which sold approximately $150

89. *See* Consent of Defendant Goldman, Sachs & Co. at 1, 3, SEC v. Goldman, Sachs & Co., No. 10-CV-3229 (S.D.N.Y. July 14, 2010), *available at* http://www.sec.gov/litigation/litreleases/2010/consent-pr2010-123.pdf.

90. *See* Jesse Eisinger & Jake Bernstein, *The Magnetar Trade: How One Hedge Fund Helped Keep the Bubble Going*, PROPUBLICA (Apr. 9, 2010), *available at* http://www.propublica.org/article/all-the-magnetar-trade-how-one-hedge-fund-helped-keep-the-housing-bubble.

91. *See* Prohibition Against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 65,355, 76 Fed. Reg. 60,320 (proposed Sept. 19, 2011) (to be codified at 17 C.F.R. pt. 230) (describing securitization transactions structured to offer a range of risk exposures and yields to investors through issuing different classes of securities, commonly referred to as tranches).

92. *See In re* GSCP (NJ), L.P., Securities Act Release No. 9252, Investment Company Act Release No. 3261, 2011 WL 3792429, at *2 (Aug. 25, 2011) ("J.P. Morgan Securities sold approximately $150 million of the so-called 'mezzanine' tranches of Squared's liabilities ('Notes') to a group of approximately 15 domestic and foreign institutional investors ('Mezzanine Investors'). All of the 10 Mezzanine Investors interviewed by the Commission staff indicated that they would have considered it important to their investment decision to have known that the equity investor in Squared took the short position for approximately half of the investment portfolio and played a significant role in the collateral selection process.").

93. *See* LEWIS, *supra* note 85, at 143 ("There weren't enough Americans with shitty credit taking out loans to satisfy investors' appetite for the end product." (emphasis omitted)).

94. *See In re GSCP (NJ), L.P.*, 2011 WL 3792429, at *1 ("While participating in the selection of CDO securities for the investment portfolio, Magnetar (who also invested $8.9 million in the subordinated notes, or equity) took the short position for CDO securities with a notional value of approximately $600 million, representing approximately half of Squared's investment portfolio."); *see also id.* at *4 ("By the time Squared closed, Magnetar's $8.9 million 'long' position from purchasing the equity was dwarfed by its $600 million 'short' position as the purchaser of CDS protection.").

95. In the Abacus hearings, discussed *supra* note 82, failing to sell the higher risk tranches did not prevent the swap of risks on the more senior or secured tranches. Since this was a synthetic instrument merely using reference points from actual securities to determine payoff obligations, so long as there are buyers and sellers who were willing to take each side of a risk at a single reference point, a swap can be done. *See supra* note 73.

million of securities in the mezzanine tranches, consented to pay $153 million to settle a SEC complaint, without admitting or denying the allegations in the complaint.[96]

C. Summary

In a securities market, as in a market for refrigerators or sofas, dealers provide liquidity that is a key economic support to one's willingness to invest in a particular asset. Knowing that there is likely a buyer for the asset if you want to sell increases the motivation to buy. Such investors appreciate that dealers are willing to take the risks of finding those parties and that the dealers will use their own money to maintain inventory so that there is a flow of exchange. Parties are happy to have the market maker as a counterparty seeking to make money on the spread.

When the market maker becomes involved in the creation of inventory, not just obtaining it on the market, there are additional asymmetrical incentives that can distort the market-making function.[97] The market maker is now not just making money on the spread, worried equally about the buyer and the seller on the dealer's round trip, but rather its interest is much more tilted toward selling than buying. In a setting where the parties are not relying simply upon express contracts and market information, but where the market maker's reputation makes an exchange possible, this conflict adds stress to private ordering.[98] It requires investors in individual transactions to worry how the skewed incentives distort their interaction with the dealer and increase their risk in the individual transaction. This can shift the supply and demand curve more generally. When such heavy incentives are piled on top of a real estate bubble facilitated by a frenzy of

96. "J.P. Morgan consented to a final judgment that provides for a permanent injunction from violating Section 17(a)(2) and (3) of the Securities Act of 1933, and payment of $18.6 million in disgorgement, $2 million in prejudgment interest and a $133 million penalty. Of the $153.6 million total, $125.87 million will be returned to the mezzanine investors through a Fair Fund distribution, and $27.73 million will be paid to the U.S. Treasury." Press Release, SEC, J.P. Morgan to Pay $153.6 Million to Settle SEC Charges of Misleading Investors in CDO Tied to U.S. Housing Market (June 21, 2011), *available at* http://www.sec.gov/news/press/2011/2011-131.htm.

97. Steven Drucker & Christopher Mayer, Inside Information and Market Making in Secondary Mortgage Markets (Jan. 6, 2008) (unpublished manuscript), *available at* http://www.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=16547 (examining "whether underwriters of prime mortgage-backed securities exploit inside information when trading in the secondary market" and concluding that "[i]nstead of acting as unbiased market makers, underwriters appear to exploit access to better information and models to their own advantage").

98. *See* Davidoff et al., *supra* note 51 (manuscript at 3) ("Trust is important in trade where . . . data about the quality of a stock issue or about market conditions is typically impossible formally to contract upon.").

speculation and leverage, market protections can fall short and, as after 1933, more intermediary conduct shifts from a market-controlled sector to one in which new government regulation appears.

III. REGULATING MARKET MAKERS: THE MENU OF CHOICES

In the array of intermediary behavior presented in Part II, several recurring constraints are visible. The most dominant constraint as to dealer behavior in securities has been reliance on the incentives and monitoring built into competitive markets. When legal tools have been added to the mix, the most common tool in securities regulation overall has been disclosure, usually regarding the securities to be sold.[99] Alternatively, rules relating to conflicts of interest of those involved in the selling of securities have either banned conflicted transactions, or required disclosure of those conflicts or consent from the opposite party.[100] In addition, American securities regulation sometimes includes governmental structuring of markets, as seen after 1933 and again with Dodd-Frank.[101] Each of these constraints is presented below before an evaluation of how each might be used in the new realities of our securities markets.

A. Market Regulation: Market Making as Reflecting Two Kinds of Private Ordering Responses

Traditional securities market making provides a classic illustration of regulation that comes from free and competitive markets. The securities of America's best-known corporations are typically available in multiple markets with various dealers making a market for the stock.[102] The level of competition is such that trading is regularized and spreads have been driven down to a very low level (as measured by historical standards).[103] A successful dealer in this market will require sufficient capital to acquire and maintain inventory and sufficient reputation that a counterparty will

99. LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 27 (3d ed. 1989) (describing the recurrent theme in federal securities regulation as "disclosure, again disclosure, and still more disclosure").

100. *See, e.g.*, 17 C.F.R. § 229.404 (2010) (requiring disclosure of transactions between the registrant and "any related person"); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828 (2010).

101. *See supra* Part II.C.

102. NASDAQ Stock Market, http://www.referenceforbusiness.com/encyclopedia/Mor-Off/Nasdaq-Stock-Market.html (last visited Dec. 11, 2011) (noting that large stocks are traded by as many as sixty market makers).

103. *See supra* note 64 and accompanying text.

have little worry about entering into a transaction.[104] The clearing house feature of trading on stock exchanges means the risk of nonperformance is spread over a pool of market participants.[105]

Private ordering between investors and market makers in dealer securities markets comes in two distinct versions. Often this private ordering takes place through market exchanges that reflect the information, incentives, and monitoring in the market and through express contracting for which the legal system provides enforcement. Sophisticated investors have the ability to protect themselves by their own evaluation of the dealer's inventory and reputation for integrity. These investors may also decline to enter into future transactions if the dealer does not provide satisfactory levels of risk as to those issues. Dealers have reason to build a reputation for integrity as well as liquidity and exposure of inventory that will bring customers back. Dealers have the normal incentives of any intermediary to pay attention to the needs of a particular customer and to provide inventory to satisfy those needs. In this setting, government regulation has the potential to stifle innovation in the creation of financial products that can more effectively allocate risk.

Sometimes, if information is unobservable or too costly to obtain and investors do not trust the counter party enough to go forward with the exchange, the market maker performs a different role, using its reputation to provide tacit promises that permit the deal to be made.[106] The importance of reputation in this second type of interaction means this subset overlaps in important ways with what an investment banker does in providing advisory services. Thus, dealer transactions in securities markets include two different market maker functions—one that predominantly relies on express contracts and markets and another that relies on reputation and tacit contracting. The two functions raise different risks as to how private ordering might fail, which in turn will suggest a different legal response. In the latter context, the market maker is performing the role more like that of an advisor with fiduciary duty and not of a pure dealer.

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104. Davidoff et al., *supra* note 51 (manuscript at 3) ("Such intermediaries place their reputations at stake when they trade; any factor, whether technological or legislative, that undermines the value of a reputation also undermines the intermediary's incentives and, hence, the level of trust that is vested in it.").

105. *See* SKEEL, *supra* note 9, at 5 ("Clearing reduces the risk to each of the parties directly, while exchange trading reduces risk to them and to the financial system indirectly by making the derivatives market more transparent.").

106. *See* Davidoff et al., *supra* note 51 (manuscript at 11).

Technological change—particularly in the last two decades—has dramatically reshaped the share of dealer transactions in the two categories. The increased ability for traders to gather, store, and analyze information via computers has expanded the space in which parties can rely on formal contracting to satisfy conditions necessary for an exchange to go forward. This is why Goldman CEO Lloyd Blankfein saw no cause for concern when asked by Senator Levin about Goldman selling a security to one client while planning to short the security: He responded, "In the context of market making, that is not a conflict. What clients are buying . . . is . . . an exposure. The thing that we are selling to them is supposed to give them the risk they want. They are not coming to us to represent what our views are. . . . They shouldn't care."[107]

Under that view of market making, conflict simply is not relevant. Yet in the other form of market making, where the parties cannot rely completely on markets and express contracting, the market maker takes a more prominent role. If all the market maker did was encompassed within the world of express contracts, there would be little to distinguish an investor trading with a market maker from an investor trading with a principal such as Paulson & Co. The market maker provides liquidity and exposure, but there is no reason why Paulson (or a computer) could not provide the same thing. Of course, the risk of nonperformance is a worry for investors, and in 2007 Paulson was not as well-known as he has since become; perhaps there would be a greater risk of nonperformance for a trader interacting directly as opposed to a market maker.[108] The status of market makers as repeat players with existing reputations can provide assurance as compared to a principal who was unknown to counterparties. Yet this insurance is limited.

The capitalization of the free-standing investment banks was not exceptionally large.[109] As derivatives and synthetic securities contracts have become more complex, the length of exposure to a dealer has grown (on both sides), and the interrelationship of risk of the financial industry

107. *See Hearing*, *supra* note 2, at 7.

108. *See* Gregory Zuckerman, *'No Big Deal' Defense*, WALL ST. J., May 1, 2010, at B1 (describing Goldman Sachs's response to the SEC suit as disclosure about John Paulson's role in Abacus was not required because he "was no big deal in early 2007").

109. FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xix (2011) [hereinafter THE FINANCIAL CRISIS INQUIRY REPORT] ("For example, as of 2007, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital. By one measure, their leverage ratios were as high as 40 to 1, meaning for every $40 in assets, there was only $1 in capital to cover losses. Less than a 3% drop in asset values could wipe out a firm.").

has expanded such that the uncertainty has increased.[110] In this interrelated dealer world, the risk of a market-making counterparty's inability to perform turns not just on the financial health of the market maker but also the health of multiple deals that the market maker has made with a host of additional counterparties in the market.

Investment banks in a dealer transaction take on a function beyond liquidity and beyond addressing the risk of nonperformance. They provide access to the broad, unfiltered market of counterparties, not just those tilted toward a participant who is paying the market maker a fee to sell a certain position. Counterparties want to see the entire run of the market, not just the offerings of a particularly informed counterparty. This parallelss the traditional desire of exchanges in seeking to pay for order flow; they want to bring to their exchange general trading rather than just trades from the "smart" money.[111] No market maker wants to be exposed only to traders with inside information, and no counterparty wants to trade with a market maker whose inventory ends up being only junk that requires a hard sale.[112] As conflict of interest becomes a greater concern on the market, investors will discount to reflect their added risk, and spreads will increase.[113] In this setting, counterparties care if market makers have

110. *Id*. at 299–300 ("At this point in the crisis, regulators also worried about the interlocking relationships that derivatives created among the small number of large financial firms that act as dealers in the OTC derivatives business. A derivatives contract creates a credit relationship between parties, such that one party may have to make large and unexpected payments to the other based on sudden price or rate changes or loan defaults. If a party is unable to make those payments when they become due, that failure may cause significant financial harm to its counterparty, which may have offsetting obligations to third parties and depend on prompt payment. Indeed, most OTC derivatives dealers hedge their contracts with offsetting contracts; thus, if they are owed payments on one contract, they most likely owe similar amounts on an offsetting contract, creating the potential for a series of losses or defaults. Since these contracts numbered in the millions and allowed a party to have virtually unlimited leverage, the possibility of sudden large and devastating losses in this market could pose a significant danger to market participants and the financial system as a whole.").

111. *See* Thomas E. Copeland & Dan Galai, *Information Effects on the Bid-Ask Spread*, 38 J. FIN. 1457, 1458 (1983) (modeling bid-ask spread as a trade off between expected losses to informed traders and expected gains from liquidity traders); Stanislav Dolgopolov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83, 89–90, 99 (2004) (suggesting assumptions needed for this statement to be true (e.g., inventory management by market makers, the time gap between the transaction in question and the absorption of the relevant piece of information by the market, and privileges of market makers allowing them to "piggyback")).

112. Fabrice Tourre seemed to express this sentiment in an email that Senator Collins asked him about at the Senate hearing. The email quoted Tourre as seeking a sales list with "fewer 'sophisticated [investors] with which [Goldman] should not expect to make too much money'" and more "'buy-and-hold rating-based buyers'" from whom Goldman could make more money because they lack sophistication. *Hearing*, *supra* note 2, at 28. Tourre said this statement was simply expressing a view that hedge funds argue more about prices. *Id*. at 29.

113. *See* Hans R. Stoll, *The Pricing of Dealer Security Services: An Empirical Study of NASDAQ Stocks*, 33 J. FIN. 1153 (1978) (discussing how increasing risk of trading with an insider leads a market

skewed incentives that prevent the market makers from performing the neutral market-making function.

B. Disclosure

Disclosure has long been the principal legal tool in regulating American securities markets, although the market-making concerns evidenced by the financial crisis suggest a context in which disclosure is a necessary, but not a sufficient, regulatory response. One focus of analysis of the period leading up to the New Deal was investors' lack of information about what they were buying in the market for new issuances.[114] The result was extensive mandatory disclosure required by the 1933 Act for issuers of securities,[115] requirements that this disclosure be reviewed by an expert government agency,[116] and that this disclosure actually be put in the hands of potential purchasers in the form of a prospectus.[117] In addition, the Act imposed a broader and more stringent liability scheme that, importantly for this discussion, used liability of intermediaries as the key enforcement mechanism.[118] The Securities Exchange Act of 1934 extended the disclosure regime to companies whose shares are traded on exchanges; in 1964, the Act was extended to companies above a certain size threshold whose stock traded on other secondary markets.[119] The substantive disclosure requirements of the two regimes have coalesced with both drawing from the common disclosure requirements in Regulation S-K,[120] but the 1934 Act disclosure remains

maker to increase the spread). Traders dealing with a market maker face a similar risk and will react in parallel ways.

114. *See* SELIGMAN, *supra* note 9, at 42–49 (describing federal securities laws as aiming to remedy weaknesses in state corporations law, exchange listing standards, and accounting rules).

115. *See* Securities Act of 1933, 15 U.S.C. § 77g (2006).

116. 15 U.S.C. § 77e (creating a waiting period between the filing and effective date of registration statements).

117. *Id.* Since 2005, the SEC has relaxed the delivery requirement so that it can now usually be satisfied by communicating a URL where the prospectus can be found. *See* Securities Offering Reform, Securities Act Release No. 8591, Exchange Act Release No. 52,056, Investment Company Act Release No. 26,993, 70 Fed. Reg. 44,722 (Aug. 3, 2005).

118. 15 U.S.C. § 77k(a) (imposing liability on underwriters, experts, accountants, and directors as well as the issuer).

119. The Securities Exchange Act originally extended to issuers on exchanges. Securities Exchange Act of 1934, Pub. L. No. 73-291, § 12, 48 Stat. 881, 892–94 (codified as amended at 15 U.S.C. § 78l). In 1964, the Act was extended to companies with five hundred shareholders and assets above $1 million. Pub. L. No. 88-467, § 3, 78 Stat. 565, 565–69 (1964). The minimum threshold is now set by SEC rule at $10 million. 17 C.F.R. § 240.12g-1 (2010).

120. 17 C.F.R. §§ 229.10–229.1208 (2010).

less stringent in terms of delivery requirements[121] and in the reach of liability provisions for failure to satisfy the disclosure requirement.[122]

Some companies did provide disclosure in issuing new securities or in annual or quarterly reports for shares that were publicly traded.[123] Academics have argued that buyers will discount what they are willing to pay for issuers that do not disclose because of the risk of what is not being said.[124] High quality issuers, in turn, have incentives to disclose and thereby distinguish themselves.[125] But concerns about oversupply and undersupply of information form the backbone for continued widespread acceptance of a government-mandated disclosure at the heart of American securities regulation.[126]

The financial crisis highlights disclosure issues beyond those in the traditional cannon of securities regulation. First, it followed a period of innovation in marketing securities that imposed new challenges on the disclosure system.[127] Companies learned they could securitize assets such as jet engines or credit card receivables or a host of other parts of their business previously enveloped within the undivided residual of the

121. Traders in the secondary market can go to the SEC web site to find the 1934 Act disclosure, *see* http://www.sec.gov/edgar/searchedgar/webusers.htm, but there is no requirement for specific delivery of notice of where the information is available for general trading transactions.

122. The principal enforcement mechanism for the 1934 Act disclosure has been under Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010), which requires more in the way of scienter and reliance than do violations in the new issue context. Liability extends only to the maker of the statement, which puts most of the enforcement activity against the issuer and its managers, rather than the intermediaries in the transaction. *See generally* COX ET AL., *supra* note 36, at 659–743.

123. The New York Stock Exchange listing standards required quarterly reports by the mid-1920s, but these listing standards only bound those who signed new listing agreements with the exchange. *See* GILBERT W. COOKE, THE STOCK MARKETS 340 (rev. ed. 1969).

124. *See generally* George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973); George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964).

125. Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673 (1984).

126. *See generally* John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

127. THE FINANCIAL CRISIS INQUIRY REPORT, *supra* note 109, at 8 ("The instruments grew more and more complex; CDOs were constructed out of CDOs, creating CDOs squared. When firms ran out of real product, they started generating cheaper-to-produce synthetic CDOs—composed not of real mortgage securities but just of bets on other mortgage products. Each new permutation created an opportunity to extract more fees and trading profits. And each new layer brought in more investors wagering on the mortgage market—even well after the market had started to turn. So by the time the process was complete, a mortgage on a home in south Florida might become part of dozens of securities owned by hundreds of investors—or parts of bets being made by hundreds more. Treasury Secretary Timothy Geithner, the president of the New York Federal Reserve Bank during the crisis, described the resulting product as 'cooked spaghetti' that became hard to 'untangle.'").

company.[128] Even more, as in the real estate mortgage market, lenders learned they could pool together large numbers of the mortgages they originated and then slice and dice those pools into various tranches marketed with different levels of risk. This securitization process moved much more of the risk of residential real estate from the banks' shareholders to a more diverse group of investors in the market.[129]

Such securitization taxed the existing disclosure system by requiring investors to aggregate large amounts of information and to understand increasingly complex financial structures. There were gaps in the market adjusting to information and to some of the complexity. As we learned deep into the financial crisis, the complex models used by many investors (e.g., value at risk (VaR)) failed to account for the black swan tail as to what valuation would be at the events at the furthest ends of the probability spectrum (where the real estate market ended up).[130]

The derivatives and swap transactions that became so prominent in the run-up to the financial crisis reflect a pattern in which information about the security itself will not be sufficient if you do not know more about your counterparty's position. The value of swap contracts turns not just on the correctness of the prediction about the future direction of value of a position but also on the ability of the counterparty to pay off.[131] Traditional disclosure is not directed toward these risks.

The financial crisis also exposed another challenge to a system based on disclosure. In a frothy market, as experienced in the period prior to the

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128. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1380 (1991) (describing wide variety of assets have been securitized: "office buildings, shopping centers and other commercial real estate (both for construction and permanent financing); credit card receivables; automobile, recreational vehicle, and truck loans; boat and mobile home loans; computer, automobile, equipment, and other leases; Small Business Administration loans; loans to franchisees of fast food restaurants and motels; loans against the cash value of life and casualty insurance policies and loans to insureds to pay for insurance policy premiums; problem bank loans; loans to Third World countries; junk bonds and health care receivables").

129. *Cf.* TETT, *supra* note 22, at 138–39 (describing vast sums of risk that remained with banks holding CDOs but which disappeared from their internal risk reports).

130. *See* NASSEM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE (2007).

131. *See* LEWIS, *supra* note 85, at 219. When the market turned in mid-2007 and short positions on credit default swaps became much more valuable, the holders could lose it all if Bear Stearns, who was their counterparty with the long position, went down. "Oddly alert to the possibility of catastrophe, they now felt oddly exposed to one." *Id.* at 220. These traders were able to exit their position by selling to UBS, who needed to offset their own long position. "[N]either UBS nor any of their other Wall Street buyers expressed the faintest reservations that they were now assuming the risk that Bear Stearns might fail: That thought, inside big Wall Street firms, was still unthinkable." *Id.* at 222.

meltdown and which has regularly occurred over the course of our economic history, behavioral patterns can overcome rational economic behavior.[132] Much of market theory and important regulatory trends over the last three decades has been based on some version of the efficient market theory.[133] The experience and the results of the financial crisis require some rethinking of that framework.[134] More recently, behavioral economics has gained traction by pointing out certain behavioral traits that may diverge from the expected behavior of rational actors (e.g., moving with the herd).[135] Keynes pointed out a similar problem with newspaper beauty contests run in the early twentieth century where the winner was selected from among those who successfully identified the most popular contestants; that is, the way to succeed was not to pick the prettiest person but to predict whom others will pick.[136] Similarly, a successful trading strategy requires predicting something about the behavior of counterparties as well as the economics of stocks.[137]

The incomplete use of disclosure by markets seen in the financial crisis and the new challenges to disclosure in the more complex and interrelated transactions that characterize many financial instruments in modern securities markets have pushed regulation beyond disclosure in a way not seen since the New Deal. Two key alternatives are discussed in the next two subsections.

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132. *See, e.g.*, Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209 (2011).

133. *See* Ronald J. Gilson & Renier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 550 (1984) ("ECMH is now *the* context in which serious discussion of the regulation of financial markets takes place.").

134. *See The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 45 (2008) (statement of Alan Greenspan, former Chairman of the Federal Reserve Board) ("I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such is [sic] that they were best capable of protecting their own shareholders and their equity in the firms. . . . [A] critical pillar to market competition and free markets[] did break down. And I think that, as I said, shocked me. I still do not fully understand why it happened . . . .").

135. Anne Rivière, *The Future of Hedge Fund Regulation: A Comparative Approach*, 10 RICH. J. GLOBAL L. & BUS. 263, 294–95 (2011) (describing how systemic risk can arise from herd behavior); Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 382 (2008) ("To some extent, investor failure in the subprime financial crisis may have resulted from herd behavior.").

136. *See* JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 142–43 (1936).

137. A statement by Citigroup's then-CEO Charles Prince epitomized this strategy: "[A]s long as the music is playing, you have to get up and dance." Nakamonto & Wighon, *supra* note 25.

C. Regulating Conflict of Interest

A conflict of interest between interacting parties is often a red flag and a recurring subject for legal rules in both securities and elsewhere. The legal concern has been most pronounced when the party in question has control over another's assets or dominance over the decision-making process and uses that position for its own benefit. A trustee who has control of the assets of the trust is the archetypical example where the law seeks to prevent conflict.[138] The conflict of corporate managers and/or directors acting for the entity in transactions in which they have an individual interest is the core of much of corporate law. The earliest legal response was to hold such transactions as void, but in recognition of the possible benefit that could sometimes accrue, the law has moved to a position that permits such transactions if cleansed of the conflict.[139] Disclosure of the conflict is regularly a part of the cleansing process together with action on behalf of the entity by an independent director or shareholders or approval by a court.[140]

Limitations on conflict occur even if one does not have dominance and control over the acts of the principal. When one party takes on a pure advisory role for a principal, even if the party is not the ultimate decision-maker, the law reinforces an expectation of devotion to the principal's interests. Investment advisers have a fiduciary duty to their clients that specifically includes a prohibition on trading opposite clients without disclosure and consent.[141] Investment banks are often expected to perform independent roles in mergers and acquisitions as part of the cleansing process for deals in which insiders have possible conflicts. In such deals, if the banks are not independent, the transaction itself will be open to legal challenges.[142]

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138. *See, e.g.*, Wardell v. R.R. Co., 103 U.S. 651, 658 (1880) ("It is among the rudiments of the law that the same person cannot act for himself and at the same time, with respect to the same matter, as the agent of another whose interests are conflicting. . . . They cannot, as agents or trustees, enter into or authorize contracts on behalf of those for whom they are appointed to act, and then personally participate in the benefits.").

139. For the classic article on this topic, see Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966) (nineteenth century view of conflict transactions as voidable gave way to permitting transactions if procedural and/or substantive standards were met).

140. *See* DEL. CODE ANN. tit. 8 § 144 (2001 & Supp. 2010); MODEL BUS. CORP. ACT §§ 8.60–8.63 (2008).

141. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-6 (2006).

142. Even here, the conflict of interest rules leave knotty problems for courts. Consider *In re* Del Monte Foods Co. Shareholders Litigation, 25 A.3d 813 (Del. Ch. 2011). An investment banking firm, Barclays Capital, first represented possible bidders in putting together a group of private equity firms

Dealers traditionally have not been subject to a blanket prohibition of conflicted positions. They do not have legal dominion over the assets or money of another. Their economic role is not presented as an advisory function in which the interests of the principal are explicitly dominant. Rather, in the normal course of business, a dealer can be expected to enter into transactions with both buyers and sellers of the same product—a conflict of interest that is part of ordinary market exchanges. Dealers view both buyers and sellers as customers. Dealers may provide advice to them about the product, but in a way that is different from an advisory relationship and more evocative of the sharing of information that occurs in the "ordinary" (sometimes aggressive) selling that goes on in markets. Buyers and sellers treat this "advice" differently than they would treat the advice they would receive in the traditional advisory relationship, even when they have a repeat relationship with dealers.

Over time, some "market" relationships have spurred restraints that reflect conflicts. Sometimes this has been triggered by asymmetry of information between the buyer and seller as in requirements that sellers in arm's length residential real estate contracts often must disclose known defects in the property.[143] The seller—who is likely the sole party in possession of the information—is not permitted to benefit from its informational advantage. Mandatory disclosure in the issuances of securities reflects a similar concern.[144]

The extension of disclosure duties to underwriters and selling dealers in the 1933 Act context is relevant to this discussion. The underwriters and dealers share in the asymmetry of information that exists for securities in IPOs. Extending the disclosure obligation to underwriters and dealers is recognition that the process of buying securities from the issuer and then selling those same securities to retail customers is designed to place securities in the hands of the public.[145] These dealer functions are

interested in taking Del Monte private. *Id.* at 822. The investment bank then sought to represent Del Monte in making strategic decisions as to its future status. Once the decision was made to pursue a going private option, the investment bank switched sides again, to represent the purchasers. *Id.* at 825–27. Because of the taint of self-interest from a conflicted financial adviser, the court found a reasonable likelihood of success on the merits of a claim that the directors failed to act reasonably in connection with the sales process. *Id.* at 837. The remedy was a twenty day delay in the shareholder vote and invalidation of the termination fee, although such a remedy may be inadequate given the conflict. *Id.* at 842.

143. *See, e.g.*, CAL. CIV. CODE § 1102 (West 2007 & Supp. 2011) (delineating a seller's disclosure obligation when transferring real property).

144. *See* Securities Act of 1933, 15 U.S.C. §§ 77e, 77j (2006).

145. *See* JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION: CASES AND MATERIALS 249 (11th ed. 2009) (discussing regulation on various participants in a distribution).

distinguished from other dealer transactions if, for example, the same dealer rebuys and resells that same stock in the same day.[146] It is not information alone that triggers this additional obligation but also the structure of the deal and the dealer's incentives that create conflicts that do not exist in ordinary dealer transactions. In the 1933 Act setting, the incentives and deal structure meant that the intermediary transaction (while carrying a dealer label in an economic analysis) had enough economic indicia of an advisory relationship that regulation of conflict was consistent with the parties' expectations.

What we saw in the 2010 hearings was a significant concern that the structure and incentives in those transductions meant dealers had interests opposite their customers in ways that were different enough from ordinary dealer transactions as to trigger additional regulation.[147] Where the market maker is not just providing liquidity, but also reputation for delivering a neutral market, legal concern about conflict of interest is also appropriate.

Goldman Sachs customers did not expect the dealer to sell them securities that the company itself thought was junk. The ban on conflicts in asset securitizations (and a broader ban on proprietary trading) in Dodd-Frank were responses to the conflict as evidenced at the 2010 Senate hearings.[148] Earlier in the decade, analysts employed by investment banks were recommending securities to clients for purchase at the same time that internal memos of the investment bank described securities in unflattering ways, indeed, in ways similar to those descriptions that got Senator Levin's attention in 2010.[149] In response, there was legislative and regulatory action to move this conduct away from caveat emptor.[150]

146. 15 U.S.C. § 77d(1) (exempting sales by one who is not an issuer, underwriter, or dealer); 15 U.S.C. § 77d(3) (dealer who is not underwriter is excluded from coverage of the Act is not selling part of original selling allotment).

147. *See Hearing*, *supra* note 2, at 9, 25.

148. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929, 124 Stat. 1376, 1852 (2010).

149. The parallels of the analyst scandals to the more recent securitization crisis include similar claims that intermediaries were selling securities they considered pieces of crap. *See Now: Vested Interest* (PBS television broadcast May 31, 2002) (transcript available at http://www.pbs.org/now/printable/transcript_wallstreet_print.html) (describing emails in probe by then NY Attorney General Elliot Spitzer); *supra* note 75.

150. *See* 15 U.S.C. § 78o-6 (added by title V of the Sarbanes-Oxley Act of 2002); Regulation Analyst Certification, 17 C.F.R. §§ 242.500–505 (2010) (requiring certification of analyst opinion and that compensation not related to specific recommendations).

D. Structuring Markets

The recent concern about conflicts in a dealer setting expands the traditional focus of securities regulation. This conflict is further away from the agency/trustee paradigm that has long defined conflict discussions, and the conflict becomes more difficult to separate from incentives that are a regular part of market transactions. In such a context, we have seen a governmental response that is less obviously directed at banning the conflicted action itself but directed more at market and governance structures that shape the underlying incentives that can cause the interests of intermediaries and their customers to diverge.

For example, there was widespread discussion in the wake of the financial crisis of various moral hazard problems in the financial industry.[151] In banks backed by government protection for depositors via insurance from the Federal Deposit Insurance Corporation ("FDIC"), managers acting for shareholders could take on more risky investments, knowing that if the risks paid off, all of the upside would accrue to the shareholders and managers, but if the risks turned out badly and the bank failed, the taxpayers would pick up the tab.[152] To the extent that the ban on proprietary trading reflected in the Volcker Rule in Dodd-Frank is aimed at banks with FDIC insurance (as opposed to a broader group of non-bank dealers who can continue to engage in proprietary trading), the ban reflects an effort to cabin this moral hazard.[153]

Apart from FDIC insurance, a similar moral hazard will arise if financial institutions perceive that they are too big to fail.[154] Managers facing a decision with risk will know that if an uncertain decision turns out well, they and their shareholders will receive all of the additional return that the market provides for taking the risk, but if the decision turns out catastrophically, the government will bail out the bank's creditors. This

151. *See, e.g.*, SKEEL, *supra* note 9, at 146–47 (discussing moral hazard in banking context).

152. *Id*.

153. While the five biggest investment banks in 2008 have become bank holding companies, merged with bank holding companies, or failed, *see supra* note 3, there are smaller investment banks that remain independent and would not be covered by the ban on proprietary trading. Under Section 619(a) of Dodd-Frank, a non-bank company supervised by the Federal Reserve Board is subject to additional capital requirements but not the ban on proprietary trading. *See supra* note 13. Barclays, a UK bank, withdrew its bank holding company status for its US subsidiary so that its investment banking unit is regulated only by the SEC. *See* David Enrich, *Banks Find Loophole on Capital Rule*, WALL ST. J., Feb. 18, 2011, at C1 (reporting that Barclays deregistered its US subsidiary as a bank holding company, moving its credit card subsidiary into a new entity that is a direct subsidiary of the British parent, and shifting its investment bank to SEC regulation).

154. *See* SKEEL, *supra* note 9, at 146–47.

can push the decisions of financial institutions too much in the direction of risky investments with too much leverage, externalizing costs onto society at large. An increase in capital requirements—to provide more of a cushion if the risky investments fail—is a structural response to such incentives.[155]

Executive compensation can create similar disincentives. Disclosure is one possible response. The SEC now requires very extensive disclosure about executive compensation that has been expanded and reworked several times in recent years.[156] But the disclosure regulation has not caused concern over executive compensation to abate. Reforms following the financial crisis brought in two additional government efforts. First, direct government approval of salaries for banks receiving aid from the Troubled Asset Relief Program ("TARP") led the government to hire Ken Feinberg to determine top salaries for companies receiving such aid (and large efforts by banking firms to get out from under TARP to free themselves of these restraints).[157] Second, Dodd-Frank mandates an advisory vote by shareholders on compensation in public companies at least once every three years,[158] and the first wave of those votes has already produced some shareholder (advisory) rejections of pay packages.[159]

Moving derivatives to exchanges and requiring clearing through clearing houses is another example of regulation aimed at structuring markets and the incentives of market participants rather than more directly regulating specific conflicts of interest. Such requirements will make trading more transparent on more standard terms in ways that will make derivatives more of a commodity and less of the one-of-a-kind transaction that meant larger risks and profits for market makers. The risk of nonperformance will move from the market maker to the clearing house,

155. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 115, 124 Stat. 1376, 1403 (2010) (providing for additional capital requirements for systemic entities deemed too big to fail).

156. *See* Regulation S-K, 17 C.F.R. § 229.402 (2010).

157. Matthew Jaffee, *U.S. Pay Czar Cuts Compensation 15 Percent at Bailout Firms*, ABC NEWS (Mar. 23, 2010), http://abcnews.go.com/Business/rulings-expected-2010-pay-cuts/story?id=10178717.

158. *See* § 951, 124 Stat. at 1899 (to be codified at 15 U.S.C. § 78n-1); *see also* Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Securities Act Release No. 9178, Exchange Act Release No. 63,768, 76 Fed. Reg. 6010 (Feb. 2, 2011) (to be codified at 17 C.F.R. pts. 229, 240, 249).

159. Joann S. Lublin, *Season of Shareholder Angst*, WALL ST. J., Feb. 14, 2011, at B10 (reporting two companies who have already gotten thumbs down about executive pay during 2011 meetings and quoting one lawyer as to the possibility of more than fifty companies losing their say on pay votes in 2011). It remains unclear how these two companies will handle the non-binding vote.

which will require both parties to meet margin requirements.[160] Generally, these changes will reduce risks to counterparties when trading derivatives, thereby reducing spreads and profits and dampening the incentives of market makers in this setting.[161]

The New Deal securities laws provide salient precedent for reform in the form of structuring markets to address incentives outside of a direct transactional context. The Securities Act of 1933, while imposing extensive mandatory disclosure on issuers, consistently sought to curb the prior dominance of the issuance process by investment bankers.[162] The statute greatly slowed down the banker's sales process, first imposing a quiet period in which sales efforts could not occur, and a waiting period of at least twenty days between filing and the effective date of the registration statement during which selling efforts were limited.[163] A required prospectus with detailed disclosures also became a necessary part of the sales process, and underwriters were made liable along with issuers for any deficiencies in the disclosure.[164] A year later in the Securities Exchange Act, disclosure obligations were extended to issuers whose shares traded on national securities exchanges,[165] but the focus of the legislation was inserting federal government regulation into the structure of the New York Stock Exchange and the trading practices of brokers and dealers.[166] In the third year of the New Deal, the Public Utilities Holding Company Act (PUHCA) went further beyond disclosure than either of the first two acts in permitting the SEC to break up the pyramid structures of public utility holding companies, including the right of the agency to seek the "death penalty."[167] Thus, the scope of regulation extended to the

160. *See* SKEEL, *supra* note 9, at 69.

161. *Id*.

162. A.C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 VA. L. REV. 841, 846 (2009).

163. *See* Securities Act of 1933, Pub. L. No. 73-22, § 5, 48 Stat. 74, 77–78 (codified as amended at 15 U.S.C. §§ 77e (2006)).

164. *Id.*; § 11, 48 Stat. at 82–83 (codified as amended at 15 U.S.C. § 77k).

165. *See supra* note 119.

166. *See* SELIGMAN, *supra* note 9, at 73 ("[T]here was no real dispute that the New York Stock Exchange was the primary object of the Securities Exchange Act of 1934, and in that year the Exchange was forced to compromise some of its independence as a result of one of the most bruising lobbying struggles ever waged in Washington."); *see also id.* at 100 (noting that "[t]he Exchange achieved an almost total victory regarding Exchange membership").

167. Public Utility Holding Company Act of 1935, Pub. L. No. 74-333, § 11, 49 Stat. 803, 820–23 (repealed 2005) (authorizing SEC to break-up the largest utility holding companies extending beyond a geographic area). Each company was limited to one geographical area, and those companies which did not satisfy the limit were to be broken up under SEC direction, a power characterized as the "death penalty." *Id.*

agency's structuring of the companies' capital structure and their corporate governance.

Franklin Roosevelt's second term brought more bills to provide social control over finance in the wake of the financial breakdown after the Crash. The Chandler Act in 1938 put an expert government agency, the SEC, at the center of the bankruptcy reorganization process,[168] displacing investment bankers and white shoe law firms.[169] The Trust Indenture Act of 1939 closed off the ability of investment bankers to go outside the reorganization process to obtain contractual modification of bonds for companies in distress.[170] The final two pieces of legislation added new federal regulation over other financial intermediaries—mutual funds and investment advisers.[171]

E. Summary

A modern observer of American securities regulation, looking from 2011, would be inclined to expect securities regulation in the form of disclosure or policing direct conflicts of interest and to minimize, even overlook, regulation of markets. In the last eight decades, the reach of the 1934 Act has expanded to take in a much larger set of companies than it did in 1934.[172] Indeed, the reach of mandatory disclosure is at a level of scope and detail that would not have seemed likely in 1934.[173] Private lawsuits yield hundreds of class actions every year producing private damages that were not an important part of the initial statutory structure of the 1934 Act.[174]

At the same time, the market-structuring aspects of the New Deal have receded. After a couple of decades of high profile constitutional challenges

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168. Pub. L. No. 75-696, § 179, 52 Stat. 840, 892 (1938) (repealed 1979). The legislation required that a court had to solicit the SEC's view in all reorganizations over a threshold. *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 125 (2001).

169. *See* SKEEL, *supra* note 168, at 125 ("Within a few years, the starring role that the Wall Street bankers had played for more than fifty years was a thing of the past.").

170. Public Law No. 76-253, § 302, 53 Stat. 1149, 1150–51 (codified as amended at 15 U.S.C. § 77bbb (2006)).

171. *See* Investment Company Act of 1940, Public Law No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64); Investment Advisers Act of 1940, Public Law No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21).

172. *See supra* note 119.

173. For example, Regulation S-K, the touchstone regulation for disclosure, now contains more than seventy items and takes up eighty pages in the *Code of Federal Regulations*. *See* 17 C.F.R §§ 229.10–229.1016 (2010).

174. A private cause of action under Rule 10b-5 was implied in *Kardon v. Nat'l Gypsum*, 69 F. Supp. 512, 513 (E.D. Pa. 1946), and confirmed by the Supreme Court more than two decades later. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11 (1971).

and dramatic reorganizations, there were no other holding companies to reform.[175] The SEC's role in business bankruptcy did not survive the bankruptcy reorganization in 1978.[176] But when the financial crisis of 2008 paralyzed modern financial markets, creating the largest financial disruption since the Great Depression, the focus of reform legislation was not disclosure or even express regulation of conflict of interest. Instead, the focus was on a new variety of ways to structure the financial industry in response to the practices and disincentives that were perceived to cause the harm in the financial meltdown.

IV. REGULATORY REFORM AFTER THE FINANCIAL CRISIS

Major regulatory reform followed the 2008 financial meltdown in less than half the time that similar reforms followed the Crash of 1929.[177] Dodd-Frank, as passed in 2010, covered a broad array of behavior in the financial sector, imposing new capital requirements for the largest American financial institutions, a new resolution authority if such firms were to fail, a new consumer finance regulatory agency, and broad new regulation of derivatives.[178] Part IV focuses on two key provisions of the reform that were responses to the conflict of interest concerns visible in the securities industry. From that core we can see the potential and difficulties of the various approaches to regulating perceived conflict of interest in modern securities markets and the methods beyond disclosure that play a newly expanded role in American securities regulation.

Dodd-Frank's two most far-reaching provisions addressing conflicts of interests of investment bankers were the authorization of the SEC to impose a fiduciary duty on broker-dealers in providing investment advice to retail customers[179] and the ban on proprietary trading by banks under the Volcker Rule.[180] Each addresses the perceived conflict of interest in investment intermediaries that was reflected in the 2010 Senate hearings. Each seeks to come to grips with the ambiguous place of market makers in

175. *See* LOSS & SELIGMAN, *supra* note 99, at 36 ("By the late 1950s, the process of putting the 1935 vintage holding companies 'through the wringer' had essentially been completed."). The Public Utilities Holding Company Act of 1935 was repealed in 2005. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1263, 119 Stat. 594, 974.

176. *See* Pub. L. No. 95-598, 92 Stat. 2549 (1978).

177. *See supra* note 9.

178. SKEEL, *supra* note 9, at 4–6.

179. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824–31 (2010).

180. § 619, 124 Stat. at 1620–31 (to be codified at 12 U.S.C. § 1851). The Volcker Rule's more visible purpose was to cabin the moral hazard of banks and the risk to taxpayers. *See infra* Part IV.B.

the prior regulatory paradigm. Each uses a different combination of the tools described in Part III. And each remains a work in progress with the statute providing only the barest of outlines for the new rules and with the possibility for exceptions that could swallow the regulatory impact on dealers and market makers.

Subparts A and B below examine each of these two major reform efforts. Using the economic backdrop described in Part II, this part focuses on the regulatory approach (among the possibilities identified in Part III) more likely to effectively address the concerns about conflict. More than the particularly severe rules of fiduciary duty suggested in proposed broker-dealer regulation or the detailed regulatory metrics sought to be used to limit proprietary trading, this part suggests a focus on market makers and the economic incentives that push them beyond the ordinary market-maker function.

A. Broker-Dealer Fiduciary Duties

The SEC staff has recommended rulemaking to impose a fiduciary duty on broker-dealers in providing personalized investment advice about securities to retail customers.[181] Congress mandated this study within a section that expressly authorizes the SEC, after such a study, to impose a uniform standard equal to that currently applied to investment advisers under the Investment Advisers Act.[182]

Investment advisers and broker-dealers occupy overlapping and not always well-demarcated space along the spectrum of securities intermediaries. Investment advisers—including money managers, financial planners, and investment consultants—tend to focus on investment advice and manage portfolios but do not execute trades.[183] Broker-dealers execute trades, make markets in securities, and in that context sometimes provide investment advice.[184] Entities tend to focus on one or the other of those functions, although one-fourth to one-third of the firms in each set do both or have an affiliate that does the other.[185] Both groups are on the frontline of investor contact, and, at that point, their separation is much harder to discern. For example, 88 percent of investment adviser representatives (the employees of the entity that is a registered investment adviser) are also

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181. SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS (2011) [hereinafter SEC STUDY], *available at* http:// www.sec.gov/news/studies/2011/913studyfinal.pdf.

182. *See* § 913(g), 124 Stat. at 1828–29.

183. SEC STUDY, *supra* note 181, at 7.

184. *Id.* at 9–10.

185. *Id.* at 12.

registered representatives of a broker-dealer firm.[186] Thus, the real person talking to an investor often has two hats—one as representative of a registered investment adviser firm and the other as a registered representative of a broker-dealer—and it not easy to tell which hat the person is wearing when dealing with an investor.

It is not surprising that investors do not keep the distinctions straight. The SEC broker-dealer report described the results of a recent study based on data from focus groups and an investor survey as follows: "[P]articipants had difficulty determining whether a financial professional was an investment adviser or a broker-dealer and instead believed that investment advisers and broker-dealers offered the same services and were subject to the same duties . . . ."[187]

Despite that perception, there has long been a difference in the legal responsibilities of the two groups (of which planners of entity structure within securities' intermediaries and witnesses who testify before Senate committees are undoubtedly aware). Broker-dealers came under federal regulation in the Securities Exchange Act of 1934.[188] The Congress of that era first mandated a study of investment advisers and then added regulation of these intermediaries by the Investment Advisers Act of 1940,[189] the last of the seven New Deal securities bills passed during the Roosevelt administration to eliminate abuses in the securities industry that Congress believed contributed to the Great Depression.[190]

The SEC study that preceded the Advisers Act "stressed the need to improve the professionalism of the industry, both by eliminating tipsters and other scam artists and by emphasizing the importance of unbiased advice, which spokespersons for investment counsel saw as distinguishing their profession from investment bankers and brokers."[191] The Advisers Act has been interpreted to impose on investment advisers a duty that has been regularly described as more severe than that for broker-dealers.[192] The advisers' duty arises from an antifraud provision of the Advisers Act

186. *Id.*

187. *Id.* at 99.

188. Securities Exchange Act of 1934, Pub. L. No. 73-291, §15, 48 Stat. 881, 895–96 (codified as amended at 15 U.S.C. § 78o (2006)).

189. Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21).

190. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

191. SEC STUDY, *supra* note 181, at 14 (describing SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES: INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES, H.R. DOC. NO. 76-477, at 27–30 (1939)).

192. *See* Coffee Testimony, *supra* note 32, at 108 (noting that broker-dealers have a much lesser obligation under suitability rules).

that tracks antifraud provisions in other federal securities statutes, such as section 17 of the 1933 Act and Rule 10b-5 under the 1934 Act, but with an additional prohibition on the adviser acting as principal for its own account.[193] The Supreme Court found that the Advisers Act's antifraud provision codified a prohibition on fraud as developed in equity courts, which included breaches of fiduciary duty within this prohibited space.[194] The Court specified that this provision imposed a duty "to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested."[195]

This description of an adviser's duty goes beyond the traditional legal duties of broker-dealers. Under the antifraud provisions of the federal securities laws, broker-dealers must deal fairly with their customers (the "shingle theory").[196] Broker-dealers must also satisfy standards of conduct from industry self-regulatory organizations (SROs) which impose a "suitability" requirement—that is, to make recommendations that are consistent with the best interest of the customer.[197] Specifically, broker-dealers are exempt from the express statutory prohibition in the Advisers Act requiring disclosure when acting as a principal in making a market.[198] More generally, they are excluded from the definition of investment advisor if their performance of investment advisory service is solely

193. *See* 15 U.S.C. § 80b-6. ("It shall be unlawful for any investment advisor . . . (1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; (3) acting as principal for his own account . . . ; or (4) to engage in any act, practice, or course of business which is fraudulent, deceptive or manipulative.").

194. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 194. By similar reasoning, fraud under Rule 10b-5 frequently took in misconduct by controlling directors or shareholders, creating an overlap with state corporate law. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (fiduciary breach of trust and manipulation and investor ignorance all part of a "single[,] seamless web"). Since the 1970s, Supreme Court decisions have confined the implied private right of action under Rule 10b-5 to a more restricted definition of fraud. *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472–73 (1977).

195. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 191–92.

196. *See* Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943). *See generally* COFFEE & SALE, *supra* note 145, at 663 (noting *Hughes* case as first appellate court case supporting SEC "shingle" theory—"when a broker-dealer goes into business (hangs out his 'shingle'), he impliedly represents he will deal fairly and competently with his customers and that he will have adequate basis for any statements or recommendations which he makes concerning securities").

197. SEC STUDY, *supra* note 181, at 62–63.

198. *See* Investment Advisers Act of 1940, Pub. L. No. 76-768, § 206(3), 54 Stat. 847, 852 (codified as amended at 15 U.S.C. § 80b-6(3)) ("The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.").

incidental to the conduct of its business as a broker-dealer and the broker-dealer receives no "special compensation" for its advisory services.[199]

The SEC study recommends a unified fiduciary standard, defined by the language suggested by Congress, that is "consistent with the standard and precedent that apply to investment advisers."[200] The SEC study states the uniform standard would incorporate sections 206(1) and (2) of the Advisers Act, which really means it would incorporate the Supreme Court interpretations of that antifraud language to include traditional judicial fraud interpretations that brought fiduciary duty within the concept of equitable fraud.[201] The study notes that the uniform standard would not, itself, extend the Advisers Act's ban on principal trading to broker-dealers.[202]

The approach extends the protections of fiduciary duty, and particularly its ban on conflict-creating behavior to a broader range of intermediary interactions traders. One of the big fights in 1934—which the New York Stock Exchange won in its showdown with the Roosevelt administration—was over the government's effort to impose more intrusive regulation of dealers as separate from brokers.[203] Now, almost eighty years later, the distinction between brokers and dealers has lost much of its significance, and the regulation of both brokers and dealers is moving toward the investment adviser standard. Left unresolved is application of the more severe standard to market making, which is a fairly large hole that remains to be filled.

The implication seems to be neutral market making is not a risk, but conflict in market making, as illustrated in the 2010 Senate hearings, would be. The SEC staff study does not suggest how to resolve this core point. One response would be a safe harbor along the lines of Rule 144(g) under the Securities Act, which permits resales of securities without registration under the 1933 Act.[204] This permitted form of sale is usually termed a "broker's transaction"; however, it does have characteristics that suggest it might be better termed an "ordinary dealer transaction" since the intermediary is permitted to go beyond the broker's role and post bid/ask spreads to buy and sell for its own account, which is the key functional

199. § 202(a)(11)(C), 54 Stat. at 849 (codified as amended at 15 U.S.C. § 80b-2).

200. SEC STUDY, *supra* note 181, at 107.

201. *But see* Arthur B. Laby, SEC v. Capital Gains Research Bureau *and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051, 1053 (2011) ("Recognition of a pre-existing fiduciary duty is not tantamount to congressional creation of a duty.").

202. SEC STUDY, *supra* note 181, at 113.

203. *See* Pritchard & Thompson, *supra* note 162, at 859.

204. 17 C.F.R. § 230.144(g) (2010).

concept that makes one a dealer and not a broker.[205] The key regulatory bite of Rule 144 is that the intermediary does no more than execute the transaction, receives no more than the usual commission, and does not arrange for the solicitation of the specific order.[206] Subpart C below suggests that instead of focusing on a market maker just being on the opposite side of a deal with a customer, there should be greater regulation of dealers as market makers where the dealer is receiving additional compensation on one side of the trade. A safe harbor based on this concept would address the large gap left in the study while addressing the key intermediary conflict that provoked this part of the 2010 legislation.

B. *The Volcker Rule's Ban on Proprietary Trading*

One of the most visible parts of the Dodd-Frank reforms was a ban on proprietary trading by banks.[207] Proprietary trading has occurred where banks' interests are most opposite customers'; it has been both profitable and a source of irritation to customers.[208] This provision, added late in the legislative process, is often referred to as the "Volcker Rule," carrying the name of former Federal Reserve Board Chair Paul Volcker who sought to wall off the more speculative lines of business from commercial banks.[209] A related provision bans bank sponsorship or investment in hedge funds.[210] These bans are a response to the moral hazard problem previously discussed when banks have federally provided insurance for deposits or an implicit guarantee from the government that they will be bailed out because they are too big to fail.[211] The result is to push them

205. *Id.*

206. *Id.*

207. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–31 (2010) (to be codified at 12 U.S.C. § 1851).

208. *See, e.g.*, COHAN, *supra* note 24, at 444 (One customer told Goldman, "I am happy to do business with you, just tell me whether you are my agent or my competitor. I am happy with either one, just not both.").

209.

> What we can do and what we should do is to recognize that curbing the proprietary interests of commercial banks is in the interest of fair and open competition as well as protecting the provision of essential financial services. Recurrent pressures, volatility, and uncertainties are inherent in our market-oriented, profit-seeking financial system. But by appropriately defining the business of commercial banks . . . we can go a long way toward promoting the combination of competition, innovation, and underlying stability that we seek.

Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs, 111th Cong. 8 (2010) (statement of Paul Volcker, Chairman, President's Economic Recovery Advisory Board).

210. § 619, 124 Stat. at 1620–31 (to be codified at 12 U.S.C. § 1851).

211. *See supra* note 151 and accompanying text.

toward more risky ventures with both higher returns, if successful, and higher chances of failure because, if profitable, the owners and managers receive all of the upside, but, if unsuccessful, the taxpayers pick up the loss.[212] A second stated purpose was to reduce conflicts of interest between banks and their customers.[213]

There are, however, two broad exceptions to this ban, which reflect the unresolved ambiguity as to how to regulate market-making behavior. Market making will continue to be permitted "not to exceed the reasonably expected near term demand of clients, customers, or counterparties."[214] Another exemption permits risk-mitigating hedging activities by banks in connection with, and related to, individual or aggregate positions designed to reduce specific risk.[215] The study of the Financial Stability Oversight Council (FSOC) in addressing the exceptions noted the intent "to preserve banking entities' ability to engage in critical financial intermediation in financial markets."[216]

Those exceptions turn out to be potentially large and a worrisome challenge for rule-makers. As the FSOC study noted, "certain classes of permitted activities—in particular, market making, hedging, underwriting, and other transactions on behalf of customers—often evidence outwardly similar characteristics to proprietary trading."[217] The study further noted, "It can be difficult . . . to differentiate a position intended to make a proprietary profit from one designed to satisfy current or expected customer demand or to provide liquidity to the markets."[218] Indeed, Goldman Sachs' "big short"—their move to a $1 billion short position in the housing market over a matter of weeks in the winter of 2007 (and a profit of $1 billion for the quarter)—was presented to the Senate Committee as exactly such: a move by the bank to hedge long positions it had taken for clients.[219] Since the fall of 2009, various banking firms have announced closings of some of their proprietary desks,[220] but the FSOC

212. *See supra* Part II.D.

213. § 619, 124 Stat. at 1620–31 (adding section 13(b) to the Bank Holding Company Act of 1956 to require a study and recommendations so as to "reduce conflicts of interest between the self-interest of banking entities . . . and the interest of customers").

214. *Id*. (adding section 13(d)(1)(B) to the Bank Holding Company Act).

215. *Id.* (adding section 13(d)(1)(C) to the Bank Holding Company Act).

216. FSOC STUDY, *supra* note 34, at 5.

217. *Id.* at 18.

218. *Id.* at 22.

219. *See supra* Part II.B.2.

220. *See* Aaron Lucchetti & Dan Fitzpatrick, *BofA Weighs Sale, Other Options for Trading Desk*, WALL ST. J., Aug. 7, 2010, at B3; Jenny Strasburg et al., *New Law Fuels a Shake-Up at Morgan Stanley*, WALL ST. J., Aug. 5, 2010, at C1.

study took note of concern expressed by some commentators that individuals may be able to continue to engage in proprietary trading in their new roles elsewhere in the bank, a concern that seems likely to remain given the contribution to banks' profits by proprietarily trading over recent years.[221]

The FSOC study, therefore, identified differences between ordinary market making and proprietary trading and proposed metrics that can be the basis for a new enforcement regime. The individual agencies charged with implementing this part of the statute proposed rules in October 2011 that include reporting obligations and a compliance system based on this study.[222]

A key part of the FSOC study, carried forward in the structure of the proposed rules, set out key economic differences in the business model of a firm following the two business plans:

- Market makers seek to benefit from the flow of trading, while proprietary traders seek to benefit from the expected appreciation of the asset;
- Market makers will seek to minimize the impact of price movements in the traded assets, while proprietary traders will seek to capture movements in price;
- Market makers use inventory to facilitate customer transactions, while proprietary traders use inventory expecting appreciation;
- Market makers tend toward rapid inventory turnover and minimal profits on the inventory held, while proprietary traders hold inventory longer with the bulk of their profit coming from appreciation;
- Market makers tend to trade at the bid quote (an indication of providing liquidity to the market), while proprietary trades would

221. FSOC STUDY, *supra* note 34, at 18 (noting concern of some commentators of transfers to capital market roles where individuals may be able to continue to engage in proprietary trading).

222. In an unusual display of joint agency action, four of the five agencies tasked with implanting the Volcker Rule—the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission—filed parallel notices of rulemaking in October 2011. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, Exchange Act Release No. 65,545, 76 Fed. Reg. 68,846 (proposed Oct. 12, 2011) [hereinafter Prohibitions and Restictions on Proprietary Trading].

more often be at the offer quote (an indicator of consuming liquidity);[223]

- Market makers will seek access to interdealer trading for liquidity and will seek access to hedging strategies reflective of a business plan based on profits from the spread and inventory.[224]

From such differences, the FSOC study seeks to separate the two types of trading by use of various quantitative metrics associated with one or more of the characteristics just described. Thus the study suggests various *revenue-based metrics* (comparing the profitability of positions on the first day they are taken against the profitability of all positions held that day), *revenue-to-risk metrics* (profitable trading days as a percentage of total days and revenue per dollar-at risk in the firm),[225] *inventory metrics* (inventory turnover and inventory aging), and *customer-flow metrics* (based on ratios of customer-initiated flows to orders from the bank itself).[226] The October 2011 proposed rules adjust these metrics somewhat, adding risk management metrics (e.g., VaR), combining the last two under a "customer facing" heading, and adding a specific focus on whether a trading unit routinely pays, rather than earns, fees, commissions, and spreads.[227]

The FSOC study concludes that "[s]upervisory review is likely to be the ultimate lynchpin in effective implementation . . . ."[228] It acknowledges that regulators would need "significant new and specialized resources" to build the infrastructure to obtain and review the data needed and to hire and train the staff that would have the quantitative and market expertise to assess this data and investigate questionable trades.[229]

The study is silent on where the government expertise for this task will reside. This was the first substantive project of the FSOC, an entity created by Dodd-Frank made up of the heads of various financial regulatory

223. "The bid" is the price at which the dealer is willing to buy the security or inventory; "the ask" is the price at which the dealer is willing to sell the security or inventory. *See* HAMILTON & BOOTH, *supra* note 52.

224. FSOC STUDY, *supra* note 34, at 22–24.

225. Since market makers seek profit from the ordinary spread between the bid and the ask quotations, they will manage inventory more tightly and seek to price each transaction to the appropriate spread, leading to less wide fluctuation on a daily pattern. *Id*.

226. *See id*. at 36–42.

227. *See* Prohibitions and Restrictions on Proprietary Trading, *supra* note 222, at 68,887–89 (discussing section IV of proposed Appendix A, which details the metrics that must be furnished).

228. FSOC STUDY, *supra* note 34, at 43.

229. *Id.* at 43–44 (recognizing that "some [a]gencies face significant resource constraints," which is likely an understatement given budget negotiations in Washington).

agencies and chaired by the Secretary of the Treasury;[230] the expertise this task requires is split between independent agencies that are the bank regulators (such as the OCC and the Fed) and the market regulators (such as the SEC and the CFTC).[231] Since the Volcker Rule is ostensibly characterized as a prohibition on banks and inserted as an amendment to the Bank Holding Company statute, the banking supervisor would seem to have the first claim to applying the rules.[232] Yet the metrics and the trades themselves are the everyday space of the trading regulators. Indeed, both the banned proprietary trading and the permitted market making and hedging are traditional functions of investment banks and had not been within the purview of bank regulators until the financial crisis and concerns about systemic risk brought them within the umbrella of prudential regulators.[233]

The debate over the financial crisis generated extensive debates about the balkanized state of American financial regulation spread along historical functional lines of banking, securities, commodities, and insurance that modern economics, technology, and globalization had overrun.[234] At the same time, the more unified regulatory structures of countries like the United Kingdom did not perform in a way to inspire

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230. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 111, 124 Stat. 1376, 1392–94 (2010) (to be codified at 12 U.S.C. § 5321) (naming the Secretary of the Treasury and the heads of the Federal Reserve Board, Office of the Comptroller of the Currency, the FDIC, the SEC, the CFTC, the National Credit Union Administration Board, the new Consumer Finance Protection Bureau, and the Federal Housing Finance Agency (should their heads be confirmed by the Senate), along with an independent member with insurance experience appointed by the President). Another section creates the Office of Financial Research within Treasury to staff this council. § 152, 124 Stat. at 1413–1415 (to be codified at 12 U.S.C. § 5342).

231. *See generally* Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599 (2009) (describing the history and function of independent agencies in financial regulation as opposed to the executive cabinet departments such as the Treasury).

232. § 619, 124 Stat. at 1620–31 (amending Bank Holding Company Act).

233. *See* Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), *available at* http://www.sec.gov/news/press/2008/2008-230.htm; *see also supra* note 3. *But see* Erik R. Sirri, Remarks at the National Economists Club: Securities Markets and Regulatory Reform (Apr. 9, 2009), *available at* http://www.sec.gov/news/speech/2009/spch040909ers.htm (explaining the consolidated supervised entities program "effectively added an additional layer of supervision at the holding company where none had existed previously," and that SEC action in 2004 regarding broker-dealer net capital rules "has been unfairly characterized as being a major contributor to the current crisis," but that the net capital rules alone could not limit the ability of the investment banks to undertake activities with the highest levels of inherent risk "outside the US broker-dealer subsidiary").

234. *See generally* Howell E. Jackson, *Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications*, 24 YALE J. REG. 253 (2007) (identifying the American regulatory system as more fragmented and inefficient).

confidence.[235] Dodd-Frank tinkered with the structure, eliminating one banking regulator and inserting the Financial Stability Oversight Council, but the regulatory structure remains a work in progress.[236] In addition, this complex, multi-dimensional new challenge is coming at a time when the government faces severe resource constraints. On a short-term basis, the SEC, for example, has been given a host of additional tasks under the financial reform legislation without the equivalent budget or employees to perform this task.[237] Clearly the necessary ingredients for the plan proposed by the FSOC are not yet in place.

The mapping of the Volcker Rule to this point reflects a prohibition on proprietary trading by banks (i.e., those transactions in which they are trading for their own account as a dealer does with a customer) unless the trade is a market-making transaction or another of the "permitted" transactions.[238] The clear implication is that these market-making transactions are OK even though the bank is taking the opposite side of the transaction from a customer just as it does in a prohibited proprietary trade. The various metrics in the proposed rulemaking are used to tell us (or at least the regulators) which is which. But then the statute adds a third layer to this regulatory line-drawing by specifying that a transaction in which the bank has a "material conflict of interest" cannot be a permitted transaction.[239] Is this simply restating the line between prohibited proprietary trading and permitted market-making transactions just discerned, or is it imposing an additional metric?

235. Dan Awrey, *The FSA, Integrated Regulation, and the Curious Case of OTC Derivatives*, 13 U. PA. J. BUS. L. 1, 48 (2010) ("Upon closer inspection, however, it would be unwise to herald the FSA as an unmitigated success for proponents of integrated regulation. The FSA is frequently described by market participants as overly bureaucratic, intrusive, and insensitive. In addition, the internal organization of the FSA—especially within the Risk Business Unit—still reflects in many respects historical divisions between the banking, insurance, and securities industries." (footnotes omitted)); John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 276 n.133 (2007) ("The FSA has recently come under some criticism in the United Kingdom for its failure to combat financial crime effectively.").

236. § 312, 124 Stat. at 1521–23 (to be codified at 12 U.S.C. § 5412) (eliminating the Office of Thrift Supervision).

237. *See, e.g.*, SEC, Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act—Dates to be Determined (Aug. 1, 2011), *available at* http://www.sec.gov/spotlight/dodd-frank/dates_to_be_determined.shtml (announcing various tasks under Dodd-Frank that it will not be able to do because of budget constraints).

238. *See supra* note 180.

239. *See* § 619, 124 Stat. at 1620–31 (to be codified at 12 U.S.C. § 1851). *See generally* Andrew F. Tuch, *Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs* (Harvard John M. Olin Ctr. for Law, Econ., and Bus. Fellows' Discussion Paper Series, Discussion Paper No. 37, 2011), *available at* http://ssrn.com/abstract=1809271 (suggesting that the conflict of interest prohibition in the Volcker Rule means independence, a reading that explains the difference in the failure to apply a fiduciary duty for sophisticated investors under the fiduciary duty standard).

The proposed rule is more confusing than helpful. The principal focus of the language of the rule on this point is to provide something of a safe harbor (adding a fourth tier to the legal analysis if you are still keeping count) by specifying that disclosure and a Chinese wall will work to cleanse the conflict (if it exists under the analysis at the previous level).[240] Yet in presenting the rules, the agencies tell us in the commentary (although not in the rule itself) that the "differing economic interests" of the buyer and seller (e.g., the market maker and its customer) would not be deemed a material conflict of interest with respect to "bona fide" market making and other transactions.[241] Thus, the third level circles back to the same place we were after the first two levels of the statutory analysis.

Our trip through Dodd-Frank rulemaking as to the role of intermediaries in securities transactions will not be complete without also including Congress's express prohibition of conflicts in certain securitization transactions, specifying that intermediaries cannot engage in a material conflict with an investor arising out of such activity for one year.[242] Here Congress included the same two broad exceptions for market making and risk-hedging and tasked the SEC to write the rules.[243] Not surprisingly the SEC concludes the exceptions should be viewed "no less narrowly" than the similar exceptions under Volcker just discussed,[244] and the Volcker rulemaking is careful to preserve potential for the securitization rules that could go beyond Volcker.[245]

240. *See* Prohibitions and Restrictions on Proprietary Trading, *supra* note 222, at 68,873 (assuming that the activities are conducted in a manner that is consistent with the proposed rule and securities and banking laws and regulations).

241. *Id*. at 68,893.

242. *See* § 621, 124 Stat. at 1631–32 (inserting section 27B to the Securities Act of 1933, banning material conflicts of interest by certain intermediaries, defined to include underwriters, placement agents, initial purchasers, sponsors, or any affiliate of subsidary of such parties, with respect to any investor in a transaction arising out of an asset-backed security, including synthetic asset-backed securities).

243. *Id*.

244. Prohibition Against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 65,355, 76 Fed. Reg. 60,320, 60,341 (proposed Sept. 19, 2011) (to be codified at 17 C.F.R. pt. 230).

245. Prohibitions and Restrictions on Proprietary Trading, *supra* note 222, at 68,893 ("[T]he discussion of that definition is provided solely for purposes of the proposed rule's definition of material conflict of interest, and does not affect the scope of that term in other contexts or a banking entity's obligation to comply with additional or different requirements with respect to a conflict under applicable securities, banking, or other laws (e.g., section 27B of the Securities Act, which governs conflicts of interest relating to certain securitizations; section 206 of the Investment Advisers Act of 1940, which applies to conflicts of interest between investment advisers and their clients; or 12 CFR 9.12, which applies to conflicts of interest in the context of a national bank's fiduciary activities").

What is interesting for our purposes is how the SEC in addressing conflict of interest in the securitization context gets to specifics that the proposed rule did not. The SEC interpreted the intent of the securitization section of the statute "to prohibit securitization participants from benefiting from the failure of financial instruments that they help structure, offer and sell to investors."[246] It observes that a securitization participant "is generally seeking to sell to investors a particular investment view regarding the underlying assets,"[247] and it finds that the securitization participant who directly or indirectly controls the structure of the securitization "would benefit directly or indirectly—from fees or other forms of remuneration, or the promise of future business, fees, or other form of remuneration."[248]

The metrics in the FSOC study offer the possibility of a solution beyond the generics of the broker-dealer study discussed in the previous part, but more specificity is likely to result from the conflict of interest rulemaking that includes a focus on market makers who receive additional consideration from one side of a market-making transaction, as reflected in the proposed SEC rule on conflicts in securitization.

C. Dealing with Conflicts in the Securities Markets

In the aftermath of various investigations and studies of the financial crisis, conflict between intermediaries and their clients has been a central focus, just as it was in 1933 in the societal examinations of what led to the Great Depression.[249] The mechanisms being deployed in the post-2008 reforms illustrate the changed face of securities regulation and also provide an opportunity to test alternative regulatory strategies. Disclosure—the dominant approach to securities regulation in the decades since the Great Depression—turns out to play a less important role in this latest chapter. That is not to say that disclosure is not important (or even that its role has not grown in response to this latest crisis), but most of the regulatory activity has been elsewhere in the reform debate after the financial meltdown.[250]

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246. Prohibition Against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 65,355, 76 Fed. Reg. at 60,330.

247. *Id*.

248. *Id*. at 60,331.

249. *See supra* note 9 and accompanying text.

250. An exception is the disclosure cleansing of the conflict of interest part of the Volcker Rule. *See supra* Part IV.B.

We have seen two types of regulatory responses. One has been directed toward conflicts that occur in a specific transactional setting between a securities intermediary and its clients/customers.[251] While new financial instruments, such as synthetics, have expanded the opportunities for market makers to trade opposite their clients in what appear to be traditional dealer transactions, there has also been a growth in the desire to regulate more of that space because of the dealer moving beyond a neutral market-making position.[252] Second, the complexity of financial relationships in a computer age, particularly the escalating power of various financial incentives, has created conflicts that need to be addressed outside the context of a particular transactional setting with bumpers inserted for various financial transactions. This government shaping of securities markets and of the incentives of the various players was a key part of the New Deal approach to securities regulation. That part of the Dodd-Frank reforms reflects a parallel pattern of the earlier New Deal reforms.

Conflict in securities markets comes in different intensities. The most intense is when an intermediary acts as an agent for investing a client's money, sometimes with express control over the decisions but with the expectation the intermediary has been retained to look out for the investor's interests.[253] Here conflicts may be banned or permitted only after disclosure and express consent by the investor.[254]

Less intense conflicts arise in traditional dealer transactions, where the core economic relationship is the dealer on the opposite side of a trade from the investor. The dealer may well have interests that conflict with the investor; some of that is inherent in any market trade. This is not seen as a problem since the investors can look out for themselves in deciding when and with whom to trade, using express contracts to protect themselves and relying on assurance flowing from a competitive market that the interests of the intermediary and the investors are sufficiently aligned.[255] The liquidity and informational benefits that the dealer brings to the market

251. *See supra* Part IV.A.

252. *See supra* Part IV.A.

253. *See* SEC STUDY, *supra* note 181.

254. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1828 (2010).

255. *See* Davidoff et al., *supra* note 51 (manuscript at 3) ("[T]echnological changes have made some investment banking activities, particularly trading businesses, more susceptible to formal contracting.").

facilitate trades by investors with varying levels of knowledge and trading needs.[256]

In between are contexts addressed by Dodd-Frank, which ostensibly are dealer transactions but where the dealer has additional relationships with one side on a trade that distort the dealer's incentives or where the market maker performs more than a liquidity function. The broker-dealer context in which the SEC staff has proposed a fiduciary duty could be such a setting, but it is not always.[257] An ordinary broker-dealer transaction will present often as a typical dealer exchange, where markets are competitive, customers can control their interaction with dealers, and express contracts are more likely to work.[258] The problematic area is the part of the rule that the SEC has not yet taken on.[259] In some cases these additional facts can make an ordinary dealer transaction look more like the first category in which the intermediary is more accurately placed as an agent of the seller or where the market maker provides an implicit contract term with its reputation filling the gaps between the parties' interests. The first can occur, for example, in a new issuance of securities where the underwriter has had an extensive relationship with the issuer and receives additional compensation for putting together the deal and bringing it to market.[260] There, for reasons already discussed, law has imposed broad disclosure requirements on the selling party.[261] The 1933 Act extends those disclosure obligations beyond the issuer to include the underwriters and broker-dealers who act as intermediaries.[262] In one sense this is a recognition that these intermediaries are stepping in the shoes of the issuer in what is a continuous transaction so that their obligations are the same as the issuer. It also seeks to counter the dealer's alignment with the issuer with interests opposite to those of the investor. This is where the rulemaking would do best to focus.

It is not just that the intermediary is not aligned with the counterparty. Market participants regularly trade with persons whose interests are opposite to their own. The core issue to be resolved, which is too often left beneath the surface, has been phrased by Donald Langevoort as "how hard [do we want] to push against the potency of salesmanship[?]"[263] Selling is

256. *Id*. (manuscript at 4).
257. *See* Part IV.A.
258. *See supra* note 255.
259. *See* Part IV.A.
260. *See supra* note 66 and accompanying text.
261. *See supra* Part II.B.1 (discussing the duties of underwriters).
262. *See supra* Part II.B.1.
263. Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 447 (2010).

a core part of our economic system, and walling off dealers can decrease the flow of securities intermediation as prior bouts of analysts' regulation may have produced less analysts' coverage.[264] But if the regulation focuses on the perceived overreaching of selling, the correct balance will more likely be struck. The additional layers of the relationship between the issuer and the intermediary create an additional conflict in removing from the market maker the neutrality that is an important part of how investors rely on markets in securities. Intermediaries perform a gate-keeping function—as seen in the role of underwriters in the regulatory system under the 1933 Act—so that investors have different expectations of a dealer than of a hedge fund or issuer or another principal.

This focus on the different role of market makers in trading opposite of investors (as opposed to other principals trading opposite the same investors) makes it easier to follow swaps and other newer financial trades in securities markets. As an ordinary market maker, the dealer trades opposite the investors on both the buying and selling side. In some transactions, as in the IPO market, the dealer receives additional compensation from one side for sponsoring and organizing the creation of the new instrument, a relationship that distorts the ordinary market-making incentives. Yet the swap context makes this relationship more opaque than in the new issue context—where it is clearly the issuer's securities that are being put into the stream of commerce and placed with investors and it is the issuer who provides the additional compensation to the underwriter. In a swap, it looks more like a simultaneous promise of two counterparties, even if one side has to go first and the market maker may initially take the other side of the first transaction in anticipation of selling (perhaps immediately) the position to a counterparty in a second transaction.[265] The harm is not that there is a party trading opposite the investor but rather that the additional relationships of the market maker deprived the investor of the neutrality of trades coming through a gatekeeper.[266]

Where the conflict concern is tied to a specific transaction and specific issuance, conflict of interest regulation is most likely to be successful. The retail market is a context in which the market is less likely to be able to correct for conflicts that interfere with the implicit trust role that market

264. *Id.* at 449.

265. Prohibition Against Conflicts of Interest in Certain Securitizations, Exchange Act Release No. 65,355, 76 Fed. Reg. 60,320, 60,321–22 (proposed Sept. 19, 2011) (to be codified at 17 C.F.R. pt. 230) (describing a swap transaction).

266. *See supra* note 51 and accompanying text.

markers take on in such a setting.[267] The process of filling out that crucial space would benefit from focusing on additional relationships that rob the market maker of the traditional neutrality and from considering the likelihood that investors have market power to constrain such conflicts. The rules would benefit from introduction of the term "ordinary dealer transaction" to parallel the concept of "brokers' transaction" used to define permitted resales under Rule 144 of the Securities Act.[268] There, the sales are permitted through transactions where the broker intermediary does no more than execute the order received as an agent, and "[r]eceives no more than the usual and customary broker's commission."[269] Here the concept of a dealer's transaction would be one in which an intermediary enters into a transaction as a counterparty buying and selling a security and receives no more than the usual and customary spread and, in particular, no additional consideration as a sponsor, organizer, or someone providing information. With such a focus, the new rules would ban the type of conflict that has been worrisome in a retail dealer setting without eliminating the economic functions that a dealer serves in ordinary securities exchanges.

The ban on proprietary trading in the Volcker Rule, while seeming sometimes to be a conflict of interest rule to address the banks' conflict with their customers, actually has a broader purpose. It moves beyond a focus on individual conflicted transactions to a focus on systemic risk.[270] Those who are harmed by the prohibited behavior are not the counterparties to the transaction but a much more diffuse group of taxpayers. Even though the ban on proprietary trading will shape how banks relate to customers that are on opposite sides of transactions with them, the broader focus of the Volcker Rule will limit its effectiveness as a conflict-enforcing rule.

First, it does not apply to investment banks that are not bank holding companies, and while that seemed small immediately after the meltdown, we are now seeing growth in that space.[271] Second, the enforcement strategy of the Volcker Rule will turn on the development of agency expertise and data that remains uncertain.[272] Third, it will be difficult not to avoid an *ex post* rule of thumb stating that if a dealer has made too

267. *See supra* note 51 and accompanying text.

268. *See* 17 C.F.R. § 230.144 (2010).

269. 17 C.F.R. § 230.144(g)(2) (2010).

270. *See supra* note 213 and accompanying text.

271. *See* Enrich, *supra* note 153 (noting that Barclays deregistered its U.S. bank holding company, leaving its investment bank regulated by the SEC instead of federal banking regulators).

272. *See supra* Part IV.B.

much money, it must have been made the bad way. It may be that rules more specifically targeted to conflict will get at the conduct we want to prohibit more effectively. This would suggest that we should focus more on the SEC rulemaking on conflicts in securitization transactions and include within the Volcker Rule parallel provisions about ordinary dealer transactions suggested above.

There is one more lesson from the meltdown. The complexity of modern securities markets is such that there are conflicts between intermediaries and their customers that are not directly tied to specific transactions. Here the better response would be market structure to address incentives that potentially distort the behavior of intermediaries and others in the markets. The derivatives reforms are the strongest example of this in Dodd-Frank and the portion of the reform that may have the greatest impact on addressing conflicts in post-computer securities markets.[273] "Say on pay" is a related structural concern that focuses more on executives than intermediaries.[274] Additional governmental requirements for banks are another tool to shape incentives of intermediaries.[275]

In 2010, as in 1933, the legislative response to intense financial crisis produced three kinds of government regulation to supplement the usual market constraints. In addition to disclosure and regulation of conflict of interests, there remains a rich use of market structure regulation. For all the talk of integration of the 1933 and 1934 Acts, there remain fundamental differences of risk to investors when intermediaries are being paid large sums to create and then sell securities.[276] Disclosure needs about securities may be the same, but intermediaries are required to play a different role when selling incentives are different.[277] Similarly, we should look to parallel economic difference to explain the core conflict

273. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 763, 124 Stat. 1376, 1762–85 (2010) (to be codified in scattered section of 15 U.S.C.) (providing rules on trade reporting, data elements, real-time public reporting for securities-based swaps, clearing agencies, and requiring mandatory clearing of some derivatives).

274. § 951, 124 Stat. at 1899–1900 (to be codified at 15 U.S.C. § 78n-1) (adding section 14A to the Securities Exchange Act of 1934, providing shareholder vote to approve executive compensation and the frequency of such compensation).

275. § 941, 124 Stat. at 1890–96 (providing for rules regarding risk retention by securities originators); *see, e.g.*, Joint Release, SEC, Agencies Seek Public Comment on Risk Retention Proposal (Mar. 31, 2011), *available at* http://www.sec.gov/news/press/2011/2011-79.htm.

276. *See* Donald C. Langevoort & Robert B. Thompson, Publicness in Contemporary Securities Regulation (unpublished manuscript) (on file with author) (recommending 1934 Act template as the default disclosure standard for securities regulation, with broker/dealer regulation based on enhanced selling incentives).

277. *Id*.

transaction of this crisis and expect to also regulate intermediaries in modern securities markets.

V. CONCLUSION

Securities regulation represents a division in the allocation of control of finance between the market and government. Dealers and market makers have occupied the crucial space for working out the relationship of the two forces, both in 1933 and more recently after the 2008 financial meltdown. The New York Stock Exchange beat back initial efforts to draft the 1934 Act as a wholesale takeover of the dealer function, and dealers continued to trade opposite their clients just as they would if they were selling cars or sofas. Indeed, the new finance has increased the space available for dealer transactions in securities, and investment bankers have argued that conflict is not really a concern.

This Article unpacks the economic and legal relationship of intermediaries, particularly dealers and market makers. There are times when ordinary dealer transactions work fine and when law limits its involvement to enforcing express contracts. There are other times when dealers fill gaps in contracts, using their reputation to create space for agreement where their contribution looks more like the trust relationship that occurs in an agency when the intermediary has agreed to act in the interests of the principal. The Securities Act of 1933 declared that the underwriting role in a new issuance was such a setting and that dealers were not permitted to rely on caveat emptor. The swaps that took center stage in the recent crisis are a parallel example in modern dress. Where the market maker has additional economic incentives that move it away from a neutral market maker seeking to make money from trading with both sides, these incentives can skew what the investors receive from the market maker. The conflict provisions in Dodd-Frank should focus on those concerns. Rulemaking under both the broker-dealer provision and the ban on proprietary trading would best focus on express conflicts when the market maker is aligned with the seller and not the investor.

Finally, there is a separate concern of conflicts that are not tied to specific transaction but to more general incentives or misincnetives that intermediaries have. The derivatives regulation in Dodd-Frank and other reforms follow in the path of market structures inserted by various New Deal securities laws. What we have seen, in 1933 and again in 2010, is social control over finance that is tailored to go beyond disclosure to include both conflict regulation and market structures of incentives.