THE IMPACT OF THE RULE OF LAW ON THE STRUCTURE AND FUNCTION OF SECURITIES MARKETS

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…a major asset of our nation (is) the integrity of our financial system.
Trust is a principle of central importance to all effective financial systems. Our system is strong and vibrant in large part because we demand that financial institutions participating in our markets operate with integrity…When confidence in the integrity of a financial institution is shaken, or its commitment to the honest conduct of business is in doubt, public trust erodes and the entire system is weakened.

– Alan Greenspan[1]

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INTRODUCTION

Most people with an interest in the securities markets/law interrelationship have tended to confuse ends and means with regard to the two principal laws pertaining to the issuance of, and trade in, securities.[2]

The overriding END of all securities regulation is to promote the public trust in, and resulting firm commitment to, financial markets. The consequence of achieving that goal is that these markets can then grow and prosper as a fundamental pillar of our democratic capitalist society.

Promoting transparency, safety and stability and fairness in securities markets are important means to that end; i.e., through registration, anti-fraud provisions and the like.

The ends-means distinction is significant. A concentrated focus on specific portions of the law, such as the registration process, exempt transactions, private placements, tender offers and anti-fraud, can cloud the actual goal. This is key to understanding the law/professional responsibility interface in securities markets. Of course, public trust and participation cannot be the responsibility of law alone. Nourishing public trust is the responsibility of market professionals as well–and of regulators, surely.[3]

It should be mentioned here, in the face of a very long bull market run, that the illusion of endless profits may seem to lessen the importance of promoting the public trust. However, when the inevitable downturn arrives–in whatever quantitative form–there will be no ingredient more important in promoting the resuscitation and growth of securities markets.

We would argue that the remarkable increase in law and regulation over the past several years in the securities markets area has had the preservation of public trust foremost in mind. We will detail some of that activity in this paper.

In Section I we will emphasize the importance of understanding the basics of the United States Rule of Law. The time is long past when either economists or lawyers, on the basis of their own singular disciplinary focus, could hope to understand, much less help shape, efficient, growth promoting market/law activity at the legislative, regulatory or judicial levels. All competitive markets/law interfaces are interdisciplinary, and can be understood only by focusing on the fundamental underpinnings of both professions.

I. The Rule of Law in the United States

There is no way to begin any discussion of the Rule of Law in the United States other than at its beginning. And that beginning is our Constitution. An extraordinary written Constitution it surely is, not because it has been the basis for many other constitutions around the world, but because it has actually worked in practice since its ratification on July 2, 1788. That a singular written document has provided, for more than 200 years, the basis for an unwavering Rule of Law in a vast nation which has seen incomparable growth in developed land mass, population and commerce, is nothing short of incredible.

No one in fact can, with unquestioned authority, explain exactly why our Constitution has continued to play the central role, successfully, in what surely is the longest run of a free, democratic republic in the history of the world.

It is not unreasonable to suggest that the answer to the durability of our Constitution might lie beyond its establishment of a tri-partite system of government with power divided between legislative, executive and judicial branches. That system is surely a remarkably effective means to an important end, but only a means, nevertheless.

We cannot go into detail here regarding the structure and function of our legal system.[4] We will focus only on the relationship between our Constitutional value system and its allied "common law" process.

In this system and process lies the basis for understanding the development and meaning of our securities (and other) laws and their impact on both the strength, and required ethical behavior, of our financial institutions.

We begin our brief focus on the Constitution by suggesting that none of its system structures; i.e., separation of powers, delineation of specific governing powers within institutions and the like are the end focus of the document. Structures are mandated because institutions must exist to nourish both structure and process. But we, the People, are kept secure by these institutions through their focus on the Constitution's goal: to ensure the permanence of the values by which the citizens of the 13 new states chose, and all succeeding generations have chosen, to live their lives.

The Constitution of the United States of America came into existence as we know it, because free citizens themselves had a hand in choosing the values it was meant to emphasize.

The Constitution, as presented to the people by the original framers, was simply NOT acceptable to the colonial majority. Rhode Island, for example, rejected it by a popular referendum vote, 2,708 to 237. Patrick Henry came within a heartbeat of defeating its acceptance by Virginia. James Madison had to save it there by agreeing to recommend a Bill of Rights to be added to the document. The Constitution faced defeat in Massachusetts as well, passing in the end only by dint of an agreement by the Federalists to fight for 9 amendments. The New Hampshire convention demanded amendments as well.[5]

No governmental institutions or processes, by themselves, could persuade the necessary number of citizens to give themselves over to a powerful central government. They had just thrown off the yoke of one across the sea, and at considerable personal cost. For them, the very purpose of a Constitutional structure was to protect the values by which their continued liberty could be assured. The basic values were spelled out in what we now know as The Bill of Rights, formally ratified and made an integral part of the United States Constitution on December 15, 1791.

We Americans understand that the right to contract and the sanctity of contracts are a bedrock of our socio-economic system. We would argue that implicit in the fierce and democratic struggle of the people, over the ultimate values to be placed in, and protected by, their constitution, was the implicit agreement that if those values were there in the document, then, upon ratification, all citizens would be bound by that Constitution utterly.

The Constitution of the United States was indeed the Mother of all contracts then, and still is now, for all of us. We suggest that it was the acceptance of that contract by the people that gave it not just its structure, but its strength and durability as well.

Of course, the values by which free men and women have chosen to live their lives, are not immutable, even though they are permanent at base.

Due process, freedom of speech, freedom of religion, separation of church and state, the writ of habeas corpus–these and other rights/values in the Constitution do not change, and cannot be done away with if we intend to remain a free Republic. However, the practical, workable shape these values assume, and how they are both protected and enforced is determined still, by a free, democratic citizenry in succeeding generations under changing conditions. The permanent struggle to give contemporary, yet lasting, meaning to our Constitution is the basis of citizen concern with what nine Justices on the United States Supreme Court do. The Justices must rely,

of course, on their own learning, skills and legal perceptions; however, to believe that they, too, are not influenced in any way by the will of the people is, to say the least, ingenuous.

The values set forth in the Constitution, as re-interpreted, but never rejected by the citizenry in succeeding generations,[6] are the foundation upon which our society is built, and by means of which it functions as it does. And property rights, the freedom to contract and access to an independent judiciary are examples of the fulfillment of these values. Upholding these values is an obligation, and our financial institutions, no less than the citizenry in general, are bound to meet that obligation or risk turning the Constitution into merely pieces of paper.

That situation has been the lot of many nations around the world who have had several incarnations of such pieces of paper, without ever effecting through them a value system capable of producing and sustaining a Rule of Law. To the great detriment of their financial systems, one might add–to name but a single consequence of functioning without a Rule of Law.

The Rule of Law in a Constitutional Democracy must function as the Constitution does: its practical, workable shape must be subject to change under changing conditions. The end of the Rule of Law being always to strengthen and uphold the values inherent in the original contract–by assuring that we and our institutions, including the financial, fulfill our obligations to uphold those values as well.

Our Rule of Law functions through a process remarkably well suited to the task. That process is "The Common Law."

The common law system originated in England and was adopted in the United States. The majority of western nations utilize a different legal process, based upon a comprehensive set of written statutes referred to collectively as a <u>Civil Law Code</u>. The answers to legal questions must proceed from what is within the Code, not from outside it. The individual statutes can be changed. But until they are, they govern all cases.

> *Our common law is different. It is generally derived from principles rather than rules; it does not consist of absolute, fixed and inflexible rules, but rather of broad and comprehensible principles based on justice, reason and common sense. Its principles have been determined by the social needs of the community and have changed with changes in such needs. These principles are susceptible to new conditions, interests, relations and usages as the progress of society may require.*[7]

The common law, in actuality, is neither loose nor unduly broad for reasons we will soon detail. However, it is certainly more changeable than is civil law. Free, competitive market managers in the United States neglect that reality at their peril, as we hope to demonstrate in Section II.

Judges do make the common law. But they must observe two very important requirements while doing so:

1. They must honor "stare decisis" which means literally that they must honor the laws that have already been laid down in very similar cases. But "stare decisis" is not inviolable. What judges who wish to depart from precedent must do is elucidate very carefully good cause to repudiate it. But they are subject to reversal by a higher (appellate) court.
2. Judges must reduce all their opinions to writing, so that they are on the record as to reasoning and result. At the trial level, there is a complete trial transcript; at the appellate level, all opinions are printed and available for reading in law libraries and, most recently, on the Internet.

These two requirements assure a satisfactory measure of stability in the law so that people and organizations might have guidance on how to act in legally-related situations.

There are plenty of statutes passed in the United States at the Federal and State level. And allied regulations, too. Nevertheless, our basic body of law is common law based, and the principle of incorporating change when necessary permeates our legal process.

Only Congress can create federal law. And since the Congress could not possibly deal with every request for bank mergers, or drug releases, or spectrum licenses or whatever, nor maintain oversight over all industries, it passes legislation appointing administrative agencies to do so ("enabling legislation"). This legislation, to put it succinctly, sets out priorities and ground rules. The administrative agency then fleshes them out.[8]

For example, the Federal Reserve must obey the ground rules for granting or denying a bank holding company the right to engage in a new business. One requirement set out by the Congress in such a case is that the new activity be "so closely related to banking...as to be a proper incident thereto.[9] Exactly what does that mean in any individual case? What the Federal Reserve says it means, within limits, of course.[10]

If the agency is alleged to have exceeded its authority; i.e., made a decision not "enabled" by the congressional statutes, they can be taken to court, and the judiciary will decide whether or not the agency (unconstitutionally) usurped the legislative power.

In the face of the large delegations of power to administrative agencies, where lies the common law concern about carefully, but necessarily, taking into account in decision-making the social needs conceptions and concerns of the body politic?

That concern, too, lies within the purview of the administrative agency–within the bounds of their congressional mandate to be sure. So agencies, e.g., the SEC, deal not only with what brokerage houses and investment banks do in fact (their actual conduct), but with what they ought to do as well (their ethical conduct).

We will deal with specifics in this area in Part II. There, in the parlance of working financial managers, we intend to descend from "the view at 50,000 feet," to some major "on-the-ground" considerations.

II. The Impact of the Rule of Law on the Ethical Behavior of Securities Industry Firms

> *As an anonymous participant in financial markets, I never had to weigh the social consequences of my actions…I felt justified in ignoring them on the grounds that I was playing by the rules…(this) makes it all the more important that the rules that govern markets should be properly formulated. The anonymous participant can ignore moral, political and social considerations, but if we look at financial markets from the standpoint of society, we cannot leave such considerations out. Although we are justified in playing by the rules, we ought to be concerned with the rules by which we play.*[11]

The preceding quotation from one of the most influential players in world financial markets raises two issues: Is it true that all participants in U.S. securities markets are "justified" in playing by the rules even with the knowledge that they are thereby causing social harm? And if participants do believe and act upon that "justification," how then are they to manifest their "concern" about "ignoring moral, political and social considerations" and the social harm they have caused? Ought they to lobby legislators to force them to be ethical?

George Soros, the source of the quotation, has actually shown his concern very clearly by being a very active personal participant in, and major financial contributor to, many socio-

political endeavors. Our purpose is not to fault him, but rather to use his quotation as a point of departure for our on-the-ground look at players and rules in U.S. securities markets.

Subject to the U.S. Rule of Law and consequent regulations, our securities markets with all their faults are still the largest, most vibrant, most liquid and most admired in the entire world. One might well argue then, that how and why we formulate and enforce our rules should be of interest to others beyond our borders.

We begin in opposition to the Soros statement that (in the fiercely competitive struggle for profits) "playing by the rules" is all that can be asked of any participant. Or that ethical behavior beyond the rules will cause the actor to be smashed by others who steer clear of ethical action.

Our contrary assertion is twofold: first, that any securities market manager who does steer clear of ethical action is not only headed for serious personal trouble, but may well be taking his firm, his stockholders, and even the reputation of his industry down with him. Second, we are convinced that ethical and socio-political insights and skills should be required of every manager with authority to act for his firm in securities markets operations. Such insights and skills are intimately related to the value of the firm.

Before fleshing out our argument with examples, we note the fact that securities markets operations encompass a staggering range of activities: stock and bond purchase and sale for retail customers, wholesale customers, private investors and government entities, underwriting, investment advising, asset management, investing for the firm's own account, mergers and acquisitions, corporate finance, merchant banking and more. But our focus here will not be on such individual sets of activities, but rather upon the what, the why and the how of the regulatory actions which apply singly, or in battalions, to them all. And our particular emphasis will be upon the relationship of these actions to ethical behavior.

We begin with an example of business organization crime and punishment.

IIA. The Federal Sentencing Guidelines

Until very recently, the idea of holding corporations themselves criminally liable for illegal actions of their employees was subject to much criticism.[12] The actual record regarding corporate conviction for crime shows that, prior to the late 1980s and the 1990s, very few cases

were even brought to court. Those that were were targeted at small companies, not larger, publicly held companies with actively traded stock.[13]

The situation changed drastically in 1991, the year in which a major governmental tool for punishing corporations–"Chapter 8"–became the law of the land. In 1984, Congress passed The Sentencing Reform Act.[14] That law set up a Federal Sentencing Commission charged with developing guidelines to deal with three basic problems: disparity in sentencing for federal crimes, uncertainty in sentencing, and an unjust lack of focus on white collar crime. Some judges, academics and lawyers were critical of the sentencing law for various reasons,[15] but it was declared constitutional in 1989.[16]

Initially, the sentencing guidelines did not deal with organizations. But they went beyond natural persons, focusing on organizational white collar crime, in 1989 amendments which were sent to Congress in 1991. A new chapter was then added to The Federal Sentencing Guidelines: Chapter 8: The Sentencing of Organizations. That chapter, with all of its provisions became effective on November 1, 1991.[17] Now organizations themselves could be held responsible for violations of any federal law. There are some 3,000 or so federal laws available for breaking, involving securities, commercial banking, anti-trust, fraud on the government and many, many more.

Chapter 8 is evidence of official government recognition of an important ethical reality: That much of the illegal action of an organization's employees arises out of the corporate culture within which they function. This is the organizational link to white collar crime.

A definition of "corporate culture" is to be found in this organizational statement to its employees:

> *Our corporate culture…is the sum total of what we believe and think, how we work together as colleagues and how we conduct ourselves as individuals.*
>
> *It is the way we treat our clients, our shareholders, our neighbors and the public in general.*
>
> *It is <u>who we are</u>.*
>
> *And while our corporate culture is by nature indefinable, it begins and ends with certain principles that underlie our success as a business and as individuals. Our future growth and prosperity depend on our continued commitment to these principles and our ability to instill them in others.*[18]

The operational market areas covered by the Federal Sentencing Guidelines are broad. Forty-six separate categories of offenses are listed under broad headings; e.g., "commercial bribery and kickbacks" is one of 6 general offenses listed under "Offenses Involving Property." Each offense arises out of a particular area of market operations covered by federal law, as stated above; e.g. federal securities law.[19]

And punishments for infractions can be severe.

The Federal Sentencing Guidelines have two distinguishing characteristics:

1. They provide very specific penalties for specified violations. Judges must apply these penalties and no others, unless their reasons for deviation are fully explained and justified, in writing; e.g., allowed on prosecutor recommendation because of the unusual extent of cooperation and assistance by the defendant. There are very few justifications for departing from the Guidelines.
2. The penalty system for organizations is based upon a government commitment to a process best referred to as "the carrot and the stick." Penalties are adjusted upward or downward within the mandated categories depending upon a) the steps the organization has taken, prior to the legal infraction, to avoid criminal conduct, and b) the cooperation with the government the organization has evidenced once an infraction has taken place. Some attention is also given to the involvement or non-involvement of high level organization personnel in the infraction.

Figure 1 lists offense levels on the left. They are based on the government's harm priorities. Minor offenses are ranked at 6 or less, more serious ones; e.g., certain anti-trust offenses can be ranked as high as 38 and above. The dollar fines are shown in the right hand column: as little as $5,000 for a minor one, $72,500,000 for a very serious one.

However, because of the carrot and stick approach, embedded in the Guidelines, a level 38 infraction would not be likely to result in exactly $72,500,000. That figure would probably be adjusted up or down.

The direction of the adjustment would be determined by several factors, particularly those set out in paragraph 2 above. Past infractions of federal law are also taken into consideration. All those elements are, together, the basis for what is referred to as the organizational "culpability score." The culpability score ranges from a low fraction up to 4. If a corporate crime is at level 38 or above, and the culpability score is at 4, the total fine then would be $290,000,000, an amount calculated to send a clear and convincing message.

Figure 1 CORPORATE FINES

Offense Level	Amount
6 or less	$5,000
7	$7,500
8	$10,000
9	$15,000
10	$20,000
11	$30,000
12	$40,000
13	$60,000
14	$85,000
15	$125,000
16	$175,000
17	$250,000
18	$350,000
19	$500,000
20	$650,000
21	$910,000
22	$1,200,000
23	$1,600,000
24	$2,100,000
25	$2,800,000
26	$3,700,000
27	$4,800,000
28	$6,300,000
29	$8,100,000
30	$10,500,000
31	$13,500,000
32	$17,500,000
33	$22,000,000
34	$28,500,000
35	$36,000,000
36	$45,500,000
37	$57,500,000
38 or more	$72,500,000

Conversely, there are actions the corporation might have taken that would mitigate the offense level, say down to 28. Given an insignificant "culpability score," the total penalty could be, say $10,000,000 rather than $290,000,000, a rather significant savings.

One major before-the-fact mitigator is the existence within the organization of "an effective program to prevent and detect violations of the law." There are 10 elements that make up such a program, and they are contained in the Guidelines manual–a publication with which all corporate compliance officers are intimately acquainted. The elements encompass compliance standards and procedure; oversight by high level personnel; due care in delegating authority; effective communication of the program within the company and steps taken to achieve compliance–included here is a "reporting system" employees might use without fear of retaliation; i.e., encourage "whistleblowing!" There are other elements, but the key is to have the organizational efforts so focused on prevention and detection as to constitute "due diligence."[20]

No organization can be asked to be, or be held to being, crime free. Neither can 100% crime free neighborhoods be the charge of a well functioning municipal police force. Of course, the government cannot force any private employee into having such a program as described before the fact. But after the fact, in addition to the severe, unmitigated penalties that could be levied against the firm, a program can then be forced upon it.

This brings us to the supreme organizational punishment, not listed in Figure 1. It is called "Probation." Organizations, in practice, go to very great lengths to avoid it, even agreeing to pay high dollar fines. An organization placed on probationary status for serious infractions will be forced to put "an effective program" in place; could be assigned an overseer appointed by the government to remain on site for a specified period of time to watch over the new program and even more general corporate activity; will have to make books and records available to the government on demand; and held to making all penalty payments in full and on time.

The Guidelines apply to all infractions of federal law subsequent to November 1, 1991 (not before). They are, to our knowledge, the only such body of law in the world focused on corporate behavior and calculated to motivate the maintenance of a corporate culture which actively promotes lawful and ethical behavior.

The word "ethics" does not appear specifically in Chapter 8. However, on the ground, in actual practice, government regulators are very much affected by the presence, or the absence, of a corporate code of ethics which actually provides support for the corporate compliance program.[21] The reason for this practical ethics requirement has been stated succinctly by the co-

author of the most important legal treatise extant on compliance programs and the organizational sentencing guidelines:

> *The dynamic nature of business crime also suggests that no compliance program can truly be effective if it neglects the broader subject of ethics. With laws (or the interpretation of laws) subject to change on little notice, ethical reasoning and instincts can act as an all-important safety net. A purely legalistic approach, by contrast, may ill serve not only ethics, but compliance itself. A limited approach may also be unsatisfying to many employees as well as to others in a company's community–such as customers.*[22]

One might posit here a hypothetical decision that must be made by a brokerage house branch manager. His star performer out there on the line (whose extraordinary production is an element helping to determine the manager's bonus) is skating closer and closer to the "unsuitability" line with several of her major customers; i.e., is putting them into higher fee, riskier, in-house investments somewhat divergent from their initially stated investment goals. But they <u>are</u> showing good profits at the moment.

Should the manager pull her up short? With the exception of clear violations of the suitability rules, there is nothing on the compliance officers' list of legal rule-based dos and don'ts that can satisfactorily make the decision for him. The manager ought to identify all the interests at stake here: his, the broker's, the firms, other brokers who watch how the star operates and customers whose accounts are being affected.

If "compliance" equals "going by the (present) book," maybe the firm would not lose a lawsuit if the market turns on the broker and her customers. The firm's argument is clear: these people knew the risks of the less safe investments with the higher possible payoff. They only sue now because they lost their bets and can no longer afford to retire. We are not legally to blame. <u>Caveat Emptor</u>.

It could be argued, to the contrary, that we are in fact much closer today to <u>caveat vendor</u>. Certainly, people given all the necessary and understandable information who choose to gamble ought to be prepared to lose–in the stock market or in a casino. But it is also true, apart from actual legal liability–which may or may not be present in our hypothetical case–that the manager is involved here with duty to one's customers, duty to the firm including to its reputation, duty to this broker and his other brokers as well who may want to skate on the same pond she does. Let us further assume that when the manager puts this question to the broker: "Have you explained

all the ramifications of these new in-house investments to your clients?" he gets the answer: "Maybe not every damn thing, but they know there's greater risk here. Besides, we aren't required by law to discuss our fee structures if they don't ask, so we don't have to be concerned about higher commissions on these products either."

Presently, compliance officers are usually listed by their firms as "ethics officers," for reasons not immediately clear to the office holder who attempts to take that title seriously. Still, it is to be hoped that the branch manager in our hypothetical, if in doubt, should have available to him an ethics officer worthy of the name.

As we shall soon see in our "soft money"; IPO "spinning"; and "clearing operations" examples, playing by the rules without ethical insight can be dangerous and costly.

But first, a final note on the Sentencing Guidelines. The Chapter 8 focus on the organization's culture and culpability is certainly not meant to derogate in any way from individual guilt which is covered in the other guideline chapters. In fact, the danger of punishment for individuals, as we shall see, has been increased as one result of Chapter 8!

Figure 2 lists jail-time penalties for individual offenders under the Sentencing Guidelines. The six columns listed under "Criminal History Category" relate solely to augmentation of penalties when there have been prior offenses by the defendant. We will assume here that the defendant has had one prior offense or none, so we are concerned only with column I. Then we shall match up the "offense level," in the extreme left hand column, with the jail time to be imposed in column I.

Let us assume an "Insider Trading" conviction.

The Guidelines list that as a level 8 offense. Therefore, the judge has the authority to impose no jail time, or up to 6 months behind bars.

However, please examine Figure 3. All offense levels are augmented by the financial severity of the crime. Therefore, in point of fact, the only time an inside trader is sentenced at as low a level as 8, is if he made less than $2,000 on the transaction—or perhaps lost money.[23] Let us assume the lawbreaker made $75,000 using inside information. (G) in the extreme left hand column tells us to add 6 to the set 8, and now we have a category 14 crime at (fairly high) "Zone C." A check of Figure 2 makes clear that the defendant now must serve a minimum of 15 months in prison. And if the profit had been $525,000, the sentencing category would be 18, which means a mandatory prison sentence of no less than 2 years and 3 months, or even 6 months longer.

Figure 2 INDIVIDUAL PRISON SENTENCES

Zone	Offense Level	Criminal History Category (Criminal History Points) I (0 or 1)	II (2 or 3)	III (4, 5, 6)	IV (7, 8, 9)	V (10, 11, 12)	VI (13 or more)
Zone A	1	0-6	0-6	0-6	0-6	0-6	0-6
	2	0-6	0-6	0-6	0-6	0-6	1-7
	3	0-6	0-6	0-6	0-6	2-8	3-9
	4	0-6	0-6	0-6	2-8	4-10	6-12
	5	0-6	0-6	1-7	4-10	6-12	9-15
	6	0-6	1-7	2-8	6-12	9-15	12-18
	7	0-6	2-8	4-10	8-14	12-18	15-21
	8	0-6	4-10	6-12	10-16	15-21	18-24
Zone B	9	4-10	6-12	8-14	12-18	18-24	21-27
	10	6-13	8-14	10-16	15-21	21-27	24-30
Zone C	11	8-14	10-16	12-18	18-24	24-30	27-33
	12	10-16	12-18	15-21	21-27	27-33	30-37
Zone D	13	12-18	15-21	18-24	24-30	30-37	33-41
	14	15-21	18-24	21-27	27-33	33-41	37-46
	15	18-24	21-27	24-30	30-37	37-46	41-51
	16	21-27	24-30	27-33	33-41	41-51	46-57
	17	24-30	27-33	30-37	37-46	46-57	51-63
	18	27-33	30-37	33-41	41-51	51-63	57-71
	19	30-37	33-41	37-46	46-57	57-71	63-78
	20	33-41	37-46	41-51	51-63	63-78	70-87
	21	37-46	41-51	46-57	57-71	70-87	77-86
	22	41-51	46-57	51-63	63-78	77-96	84-105
	23	46-57	51-63	57-71	70-87	84-105	92-115
	24	51-63	57-71	63-78	77-96	92-115	100-125
	25	57-71	63-78	70-87	84-105	100-125	110-137
	26	63-78	70-87	78-97	92-115	110-137	120-150
	27	70-87	78-97	87-108	100-125	120-150	130-162
	28	78-97	87-108	97-121	110-137	130-162	140-175
	29	87-108	97-121	108-135	121-151	140-175	151-188
	30	97-121	108-135	121-151	135-162	151-188	168-210
	31	108-135	121-151	135-168	151-188	168-210	188-235
	32	121-151	135-168	151-188	168-210	188-235	210-262
	33	135-168	151-188	168-210	188-235	210-263	235-293
	34	151-188	168-210	188-235	210-262	235-293	262-327
	35	168-210	188-235	210-262	235-293	262-327	292-365
	36	188-235	210-262	235-293	262-327	292-365	324-405
	37	210-262	235-293	262-327	292-365	324-405	360-life
	38	235-293	262-327	292-365	324-405	360-life	360-life
	39	262-327	292-365	324-405	360-life	360-life	360-life
	40	292-365	324-405	360-life	360-life	360-life	360-life
	41	324-405	360-life	360-life	360-life	360-life	360-life
	42	360-life	360-life	360-life	360-life	360-life	360-life
	43	life	life	life	life	life	life

The operational word is “mandatory.”

The defendant may be a wonderful parent, scout leader, devout churchgoer and with no criminal record of any kind–not even a speeding ticket. And his lawyer may be able to bring to court a gaggle of witnesses to testify to his otherwise sterling reputation. All of that is irrelevant. He will have to serve at least the mandatory minimum. To that point there is no judicial discretion. Maybe this defendant will avoid the maximum in the category, but that is all the hope there is.

All of which might suggest the helpfulness of an ethical sensitivity before the act. But if the impact of government law in these cases is not yet perceived as too serious, we might go further and point out the following:

Let us assume that an offense level 9 defendant, who made only $4,500 on his “inside” trade, banked his ill gotten gains, or wrote a check for some legitimate purpose using some or all of that money. She has then engaged in a “structured financial transaction” dealing with the “proceeds of unlawful activity.”

The legal term for that is “money laundering.”

The offense level for money laundering begins at 21. Add 1 to that, it becomes 22: a mandatory minimum of over 3 years behind bars. Not to mention a gain from the original transaction of $510,000. That makes 31 and a mandatory minimum of 9 years behind bars. Remembering always that a federal prosecutor has discretion in deciding whether or not to actually indict an individual or a corporation, and just which count(s) to charge them on, the leverage power here is tremendous. Imagine, if you will, being guilty of insider trading, and a reasonable (temporary) profit, and being told by the federal prosecutor: “You have 3 choices here. Stand tough and be indicted on the counts of insider trading AND money laundering; plead guilty and we drop the money laundering count; turn in <u>everybody else</u> involved in this insider deal, and, if they are sufficiently substantial, you get immunity from prosecution.” Clearly, if you are one of the “everybody else,” your days outside of jail are numbered.

The reality is that a common occurrence in a prosecutor’s ante room is the presence of several lawyers and clients at odds about who got there first; i.e., who is entitled to go in first to the prosecutor and get a deal not helpful to all the others.

The potential severity of penalties for individuals under the current insider trading law can now be placed upon inside trades with no fiduciary duty to anybody for anything if the trader

Figure 3 MULTIPLIERS

PART F – OFFENSES INVOLVING FRAUD OR DECEIT

2F1.1 Fraud and Deceit; Forgery; Offenses Involving Altered or Counterfeit Instruments Other than Counterfeit Bearer Obligations of the United States

2F1.2. Insider Trading

2F1.1 Fraud and Deceit; Forgery; Offenses Involving Altered or Counterfeit Instruments Other than Counterfeit Bearer Obligations of the United States

(a) Base Offense Level: 6; Insider Trading Base Offense Level: 8

(b) Specific Offense Characteristics

(1) If the loss exceeded $2,000, increase the offense level as follows:

	Loss (Apply the Greatest)	Increase in Level
(A)	$2,000 or less	no increase
(B)	More than $2,000	add 1
(C)	More than $5,000	add 2
(D)	More than $10,000	add 3
(E)	More than $20,000	add 4
(F)	More than $40,000	add 5
(G)	More than $70,000	add 6
(H)	More than $120,000	add 7
(I)	More than $200,000	add 8
(J)	More than $350,000	add 9
(K)	More than $500,000	add 10
(L)	More than $800,000	add 11
(M)	More than $1,500,000	add 12
(N)	More than $2,500,000	add 13
(O)	More than $5,000,000	add 14
(P)	More than $10,000,000	add 15
(Q)	More than $20,000,000	add 16
(R)	More than $40,000,000	add 17
(S)	More than $80,000,000	add 18

(2) If the offense involved (A) more than minimal planning, or (B) a scheme to defraud more than one victim, increase by 2 levels.

(3) If the offense involved (A) a misrepresentation that the defendant was acting on behalf of a charitable, educational, religious or political organization, or a government agency, or (B) violation of any judicial or administrative order, injunction, decree, or process not addressed elsewhere in the guidelines, increase by 2 levels. If the resulting offense level is less than level 10, increase to level 10.

(4) If the offense involved (A) the conscious or reckless risk of serious bodily injury, or (B) possession of a dangerous weapon (including a firearm) in connection with the offense, increase by 2 levels. If the resulting offense level is less than level 13, increase to level 13.

(5) If the offense involved the use of foreign bank accounts or transactions to conceal the true nature or extent of the fraudulent conduct, and the offense level as determined above is less than level 12, increase to level 12.

(6) If the offense –

(A) substantially jeopardized the safety and soundness of a financial institution; or

(B) affected a financial institution and the defendant derived more than $1,000,000 in gross receipts from the offense,

increase by 4 levels. If the resulting offense level is less than level 24, increase to level 24.

knew, or should have known, that he was using inside information in connection with a tender offer.[24]

The severity of the penalties for individuals under the Guidelines places in stark relief the way in which the Guidelines' corporate punishments can lead individuals into a trap. There are three new actions an organization must take if it hopes to get a substantial mitigation credit from the government after a crime has been committed: promptly reporting the problem; cooperating in the investigation; and/or accepting criminal responsibility. Organizations can, and sometimes do, accept criminal responsibility outright, pay huge dollar penalties and avoid actual indictment for a crime. More often, however, they fully cooperate with the government before accepting criminal responsibility in order to have others (employees) shoulder a good part of the blame, which results in less penalties for them. The corporate cooperation must include all information "sufficient for law enforcement personnel to identify...the individuals responsible for the criminal conduct.[25] As between the organization and the individual employee, the choice of the organization is clear enough: the employee is going to take the fall. In this connection, it is clear that attorney-client confidentiality may well be waived by the organization, leaving the employee without that defense in terms of anything he has confided to a company lawyer. Moreover, in "cooperating," the organization, in a sense, has become an investigating arm of the government. The serious affect on employees has not gone unnoticed.[26]

Any corporate employee in or out of the securities industry ought to understand the importance of federal sentencing laws. And while sensible ethical (fairness) arguments may be made on either side of the strong prosecutorial leverage issue here, or on an organization's willingness to sacrifice its own, one thing is surely clear: The impact of this government law and regulatory process on the ethical behavior of the firm, its managers and all its employees is tremendous.

There are clear benefits to a securities firm in avoiding indictment, conviction, heavy fines and being placed on probation. But we would suggest that there are good reasons for emphasizing the long term benefits from creating a "compliance culture" apart from simply penalty avoidance. Particularly by making compliance a subset of ethics. Employees react positively to an ethics program in which the management leads by example far more positively than to one which says, in effect: "We are not in business to worry about the moral and social consequences of our acts. What we want you to do are two things. First learn the rules from the

compliance department and be damn sure not to break them. Second, meet your bottom line requirements and how you do it is your responsibility.[27]

The Federal Sentencing Guidelines are not the only example of incentives urging organizations to recognize changing social standards and to take preventive action to avoid harm. The recent Supreme Court cases interpreting the Equal Employment Opportunity Guidelines on Discrimination Because of Sex, and specifically sexual harassment,[28] laid down some legal rules on organizational responsibility. The two major cases[29] made clear that:

- If an employer exercises reasonable care to prevent and correct promptly any sexually harassing behavior, and
- If the employer unreasonably fails to take advantage of these prevention and correction opportunities,[30] and
- If the employer didn't lose its preventive, corrective program defense by taking some "tangible employment action" against the employee; e.g., by failing to promote her, then

the employee cannot recover anything in a sexual harassment lawsuit.

Without such a program in place, the firm is clearly responsible for sexual harassment by a supervisor, whether it actually knew about it or not. Having had such a prevention/correction program in place, before any legal rule required it, saved Wal-Mart Stores a lot of money in a case in 1997: $4,650,000 dollars to be exact. A sexual harassment plaintiff's $5 million punitive award was cut back to $350,000 on the basis of the defendant's having had a program in place to deal with this serious concern.[31]

IIB. Keeping Up With the Spirit of the Common Law–and Ahead of the Rules: Three Current Illustrations

1. IPO "Spinning

In the world of Wall Street "spin desks" (as of 1997):

many investment banks silently allocate chunks of hot new stocks to the personal brokerage accounts they hold for corporate executives and venture capitalists–"spinnning" or "flipping" the shares on the day of the IPO for quick profits–in an apparent bid for business from the executive

firms…'At its extreme an IPO is priced Wednesday. Thursday morning you call 25 venture capitalists and say: "by the way, XYZ just went public at 15. It's now 30. You just sold your allocation at 29 ½. I hope you're happy.'[32]

Should this kind of spinning be looked at as a quid pro quo? If so, see the problem. The executive who takes the profit has to deal with the issue of breach of fiduciary duty. Fiduciary duty posits a very special relationship between principal and agent. One aspect is that the fiduciary has an affirmative duty not to profit by virtue of his position as a fiduciary; another is an affirmative duty to disclose to the principal any and all information in his possession that bears upon any decision the principal is to make. Both duties are not consistent with taking spin money as, say, a chief financial officer of X Company, or helping to decide on using the spin profits' investment bank to underwrite X Company's new stock issue.[33]

The "spin" broker's refrain is, of course, "everybody does it and they always have." Then comes one of society's message bearers (media) in the form of the Wall Street Journal. And the practice is exposed to the light of day for all those in and out of the game to see–and with easily perceivable distaste. The "justice, reason and common sense" of the common law process[34] is set in motion. There are certainly other ways to get change started, but our media message bearers rank high on the list.

It would be overstating the case to say that spinning is now extinct. However, the SEC is now all over the process, and if not abandoned, spinning is down by a considerable degree. And those who insist on playing that game are now opened up to lawsuits.

Many firms who spun and then "flipped" IPO stock for major firms' officers (turned it over quickly for a profit) have been preventing lesser customers of the firm, who manage to get a small piece of an IPO, from "flipping" the very same stock. The method used is to inform all of the firm's brokers that if their regular course of business customers do not retain their stock for 20 or 30 or whatever days, then the broker loses his commission on the original sale.

State securities regulators have come down heavily on that one as a "dishonest and unethical business practice" that puts the firm's brokers in direct contravention with

the financial interests of their customers. Massachusetts regulators have charged brokerage firms with wrongdoing here and have stated that "requiring firms to abandon (these) policies is one of the more severe sanctions we will impose."[35]

2. "Soft Dollar" Services

Investment managers often get an array of services from many brokerage firms to whom they give their business. It has even been estimated that the soft dollar brokerage business accounts for as much as 40% of all stock trading.[36] Soft dollars are certainly not all unethical. Some of the higher commissions (soft dollars) paid to brokers result in an investment manager being provided with valuable extras; e.g., independent research such as stock reports and data feeds, which do not come automatically with purchase and sale execution. That is not a kickback from the broker, rather it is a return for the higher commission paid. However, investment managers rarely inform their clients that they are actually paying higher than normal broker fees, nor, certainly, what they are getting in return. A large problem, surely, when the broker returns part of the excess fee; e.g., in the form of payment for new top-of-the-line furniture for the manager's office.

The result of public exposure to the soft dollar phenomenon was an 18 month "sweep" of 250 investment advisors and 7 broker-dealers by the SEC's Office of Compliance. The concern of Chairman Levitt went beyond excessive commission rates to such areas as the overtrading of accounts, and inferior execution by less efficient brokers to satisfy a soft dollar obligation.

Subsequent to the compliance report, the SEC moved to tighten up section 28(e) of the securities laws (which does not prohibit soft dollars per se). Full disclosure to clients is the watchword now and, in the case of the $5.5 trillion dollar mutual fund business, better disclosure to investment advisors' boards.[37]

3. Securities "Clearing Firms" and Responsibility For Activities of Their Customers.

We have one last example now of a sea change in securities market processes, arising not out of formal legal change, but rather out of a changing social concern about certain types of behavior affecting the investor public.

Actually, it should be recognized that brokerage firms and investment banks affect the public welfare, generally, not just the welfare of investing clients. First, because they are key to the stability of the financial system which affects us all. And secondly because many of them are in the category of too-big-to-be-allowed-to-suffer-the-consequences-of-their having failed. Thus have some of these firms been bailed out of looming catastrophe by the Federal Reserve. Indeed, it is an article of faith in the investment community, that they will continue to be bailed out when, and if, financial markets are broadly threatened, just as commercial banks have been. It is surely arguable that the lofty height of the stock markets is not unrelated to a safety net subsidy, and there is an ethical issue of some significance.

October, 1987 is but one example of this subsidy. But what is not so commonly known is that severe constraints on brokerage firm access to the Federal Reserve lending window were removed by a section of the relatively new FDICIA laws in 1991.[38] Further, the brokerage industry's insurance fund is dependent in the end upon the lenders of last resort–the taxpayers of the United States–that fund, the SIPC, has a line of credit with the Treasury Department of hundreds of millions of dollars. All financial institution bailouts have, at bottom, the deep pockets of taxpayers.

The last Federal Reserve involvement in a serious market failure in the securities business involved the hedge fund, Long Term Capital Management (LTCM). It has been argued that the Fed's effort to get LTCM creditors together to bail out LTCM and avoid a fire sale of its assets that would "distort market prices" and "produce large losses, or worse for a number of creditors and counterparties"[39] involved no public money. That argument is not wholly true.[40]

The U.S. creditors who stood to lose heavily included U.S. commercial banks with deposit insurance and securities firms with implicit taxpayer guarantees. And losses would hardly have been confined to loans outstanding, either. "It seems almost certain that banks and securities firms also had significant exposure as counterparties to LCTM's sways positions."[41] LTCM had to be saved because, among other things, taxpayer money was at risk. If the Federal Reserve is to be thanked for keeping the axe from falling on us, it should also be asked why it does not insist on some punishment for financial firms who fail in their duty as "public stewards" as they did here through the extent of their

questionable investments in a firm which may well have failed because of "arrogance, avarice and its resulting leverage."[42]

In any event, the common law concept of focusing "on broad and comprehensible principles based on justice, reason and common sense" should give us hope that, eventually, in the face of safety net subsidies,[43] responsibility for the public good may well be imposed upon those who tend to lose sight of it in the midst of what can be overzealous wealth maximization practices.

Some clearing firm "activities" can fall in the overzealous category.

Clearing firms are trade processors. They are large brokerage houses which are hired by smaller firms (called "introducing brokers") to execute trades for them, maintain client records, send out trade confirmations and monthly statements and also settle the smaller firm's transactions. By this clearing firm arrangement, the introducing broker is able to use the cachet of the powerful, well-known firm, and the powerhouse firm is able to make a tremendous amount of money.

The clearing firm requires introducing firms to put up a deposit, usually some $250,000. It also levies a "ticket charge" of $10 to $25 on each trade it conducts for the introducing broker. It also charges interest, usually 1% per month on margin loans it makes to these customers.[44]

Since 1982, when commissions were deregulated, clearing firms have not had legally determined oversight responsibilities for their introducing brokers. The operating principle has been to provide the service and earn the money for any introducing broker who hasn't yet been thrown out of the business. The ethical (or even illegal) character of the still-in-operation introducing firm was not regarded as the business of the clearing firm in any way.

Then A.R. Baron & Co., an introducing broker to its clearing broker, Bear Stearns & Co., went bankrupt. Baron was also charged by the Manhattan (New York City) District Attorney with being a criminal enterprise that defrauded investors out of $75 million dollars.

Bear Stearns, whose clearing operations represented more than 25 per cent of its multi-billion dollar business in recent years,[45] came under fire in connection with the

A.R. Baron debacle. Bear Stearns cleared for Baron in 1995, when Baron's credit was so bad it was unable to qualify for a corporate gasoline credit card. In that same year, Baron paid $1.5 million in fines in an NASD settlement where it was alleged that it executed trades for customers at unfair and unreasonable prices. By the end of that same year, Baron's capital fell below the regulatory minimum. Additionally, a Baron customer notified Bear Stearns of unauthorized trading in its accounts. Bear Stearns simply referred the matter back to Baron. In October of 1995, Bear Stearns injected $1.1 million of its own money into A.R. Baron to keep it afloat when its capital once more fell below the statutory minimum. The SEC ordered Baron to halt all operations in May, 1996. It filed for bankruptcy two months later, and less than a year after that came under formal investigation by the Manhattan District Attorney.[46]

By early June of 1997, the NYSE and NASD had their officials meet with several clearing firm officials. One firm, Oppenheimer & Co., announced plans to stop processing trades for any introducing broker client accused by regulators of charging excess commissions.[47] Bear Stearns' position was that a clearing broker had neither access to, nor control over, any introducing broker, and if subjected to customer claims, might well get out of the business altogether.[48] The SEC took the position that the Bear Stearns' matter was not even an issue about higher clearing standards, that it was "about a firm that did nothing to stop a fraud and plenty to perpetuate it."[49] The SEC then let Bear Stearns know it was preparing to consider making civil securities fraud charges against it (with attendant Sentencing Guidelines penalties if the U.S. Attorney went further with criminal charges). A settlement was reached with Bear Stearns agreeing to pay a fine, and restitution to A.R. Baron customers of $25 million. The agreement apparently was that Bear Stearns "contributed to" A.R. Baron's activities–something short of "aiding and abetting" fraud. Bear Stearn's senior executive in charge of its billion dollar a year clearing business later resigned.[50]

The key question here is not why Wall Street firms would accept no responsibility for introducing brokers actions for a long time; rather it is how could a major investment bank fail to see changes blowing in the wind? Hubris may well be part of the answer. But an argument could be made that Bear Stearns' admittedly strong compliance culture (nobody here is allowed to break the law), did not focus on ethical sensitivity at all. The notion that all action still legal is per se ethical and beyond punishment, is not true in fact;

e.g. Nazi functionaries acted in accordance with then German Law, and is, additionally a dangerous notion in the face of our common law tradition.

4. The Securities Industry in Cyberspace

We have no ability to predict the future of securities markets in cyberspace. But we are able to relate to cyberspace issues giving rise already to questions of law and regulation. Our assumption is that the Rule of Law will prevail, even on the Internet. If it does not, competitive markets as we know them now will cease to exist, and meaningful discussions on the issue of securities will be limited to self-defense and survival.

This is not to say that our basic constitutional values will not take new workable, practical legal and regulatory shapes that cannot now be foreseen. But if private property rights and the sanctity of contracts are to prevail, so must fundamental fairness to the free citizens of a democracy. In its absence comes the kind of social concern and even social upheaval that saps both the spirit and the efficiency of the Republic. All changes to fundamental unfairness in our society, whether it be poverty in the midst of plenty or lack of adequate medical care for tens of millions in a society with the finest medical procedures in the world–all such challenges bring problems. There are problems for the political process, and a great deal of cost to the taxpayer, albeit in indirect ways, and in some meaningful measure these problems end up adding to the massive workload of the judicial system.

It is not likely that due process fairness will disappear in cyberspace on the ground that nobody can be expected to determine and enforce the rights and responsibilities that ought to exist out there. "Cyberspace ethics" is not an oxymoron.

> *Market executives are thinking about this already: It's interesting that, right now, even though times are good for most folks on Wall Street, we face some unique ethical challenges in the stock market…the ethical requirements of our business are increasing because of the juxtaposition*

of technology and the increased participation in financial markets by the average American.[51]

We will focus here on just what those "ethical requirements" ought to be for securities firms–not on broader cyberspace issues such as where the overall responsibility should lie for governing the Internet.[52]

The advent of on line trading has already changed the structure of the securities industry. According to recent data, more that 6.3 million U.S. households had on line trading accounts as of April, 1999.[53] On line transactions in 1998 rose from less than 11 percent of total stock trades in the first quarter to 13 percent in the fourth quarter. Given that 400 billion shares of stock were traded on U.S. exchanges in 1998, that constitutes a lot of cyberspace transactions. And according to the Wall Street Journal the top 10 trading firms control over 91 percent of the total business.[54]

Outside of cyberspace, where almost all of us still live and conduct our business, there are legal and ethical constructs for promoting proper behavior in broker-client relations.

All stockbrokers, mainly because of the asymmetry of information that exists between the buyer and seller of securities, have some form of legal duty to every single client. The extent of that legal duty depends on two central factors: the nature of the service relationship between the parties with regard to the transaction being done, and the extent of the information asymmetry between them.

A broker receiving a simple buy order from a sophisticated client has a duty to that client. But it is limited to the quality of execution only; i.e., proper timing and price. How that stock performs is the client's risk, not the broker's. At the other end of the scale is the elderly widow, completely lacking in market experience, who comes to a broker for advice on how to invest her nest egg which is now $250,000 in bank CDs. Even here the broker's duty may not be at the level of fiduciary; however, the broker better get a lot of information on this widow's preferences, risk profile, total assets and the like before making his investment recommendations. The duty of care here is far higher than to our first client. And if the broker is handling a "discretionary" account; i.e., has full authority to buy and sell for the client's portfolio according to the broker's

best judgement only with no need for permission to make specific trades, then the broker's duty is fiduciary, and that is a very high duty indeed.

The Orange County debacle of 1994, which ended up with the collapse of the county's investment pool, $l.6 billion in losses, and the largest municipal bankruptcy filing ever in the United States, is a good example of the seriousness of the broker duty to its various clients.

Following the bankruptcy, Orange County sued Merrill Lynch, its major brokerage house, other investment banks, accounting firms and law firms as well. All the lawsuits went forward on the same basis: that the defendants did not fulfill their duty to the county/client to disclose to them fully the nature and extent of the risks to which their investment pool was being subjected.

Since the investment pool consisted of public funds, one issue was whether these defendants had a higher duty of care than they would have with private investors–clearly a relationship issue. The investment manager for the county, it was argued, was less sophisticated than he pretended to be, and was taken advantage of, for profit. Merrill Lynch argued that the manager was very sophisticated and knew exactly what the risks were. Who disclosed what to whom, and who fully understood whatever, are questions of fact for the jury. For us to pursue them here would be an utter waste of time.

Our interest is in the level of the duty of care owed by Merrill (and the others) to this particular investor. If this case had gone to trial, the jury would have had to determine the truth of who said what, when, how, and what was understood and what wasn't. But only the judge could define the level of care owed to the county by the defendant. The jury would have to fitted their found facts to the legal standard of care defined by the judge. It would have been interesting to know exactly how that standard would have been legally defined; however, none of the parties apparently were anxious to find out. All the cases were settled. Merrill Lynch paid $437.1 million to Orange County, and $30 million more to county criminal authorities to settle their ongoing probe. All the other defendants settled for a total of $204.1 million. When all the interest was added on, the total collected by the county of their $1.6 billion loss, was $860.6 million.[55] Whether that final figure represents an ethical conclusion to that sorry matter is a subject

for a different paper. The focus for us is the importance of determining the nature of the legal duty owed in these and similar broker-customer securities matters.

Including those arising out of transactions in cyberspace. The determination of the nature of rights and duties on line, under our Rule of Law, will depend on preserving the public trust in, and commitment to, the good health and growth of securities markets, whatever may be the technological parameters.

It is clear enough that securities markets transactions in the 21st century will take place on a playing field far different from the one with which the 20th century has been familiar.

"On line" trading is a coverall term for securities (and soon enough, debt paper) transactions entered into and completed on the Internet using computer processes. Some customers trade on the Internet much as they would on the ground: with a broker's advice, or data provided by her or her firm, with an eye toward risk tolerance, present financial position, ultimate investment goals, and some substantive information on the companies in which they invest.

Then there are "day traders," whose goal is immediate profit. They often know nothing at all about the company whose shares they buy and sell, other than the direction in which they and their industry as a whole perhaps have been moving. And trading as they do several times in a day, they may well lose sight of their current financial position.

Prior to 1997, technological inefficiencies in the market had provided opportunities only for fast acting professionals in possession of equipment and access to data, with the opportunity for rapid daily profits. Then came the NASDAQ collusive, point spread scandal which had two important results. First, the many brokerage firms allegedly involved in maintaining wider point spreads in order to heighten profits, paid out more than $1 billion in settlements. More important, new NASDAQ Trading Rules were put into effect, providing greater data access to non-professionals through more prominent display of their stock orders on the NASDAQ system. Day trading could now become a game for everyone.

There are those who argue that day trading is indeed a fine example of financial democracy at its best. That given the existence of so many powerful computers and

relevant software programs in the hands of the ordinary investor, the mechanics of the day trading game are now the same for everyone.

There are two basic ways to day trade: from home, mainly in association with a firm that maintains high speed access lines for day trader use, or perhaps a mainstream on line brokerage house whose executions usually take longer than a singularly focused high speed day trading firm. The second way to day trade is to use the office of a day trading firm to transact your personal business. These firms have the computers and the Internet connections, let customers trade for themselves, and take their commission on each transaction. The head of the Electronic Traders Association has been quoted as saying that there are 70 such day trading offices located throughout the United States where some 3000 to 4000 persons come each day to participate in the game.[56]

Both at-home and at-the-office day traders may well be in and out of stock positions several times a day and, apparently, most of them lose money.[57] Clearly, day traders do not constitute the major portion of <u>all</u> on line trading, and abuses in the practice do seem to be exposed more or less quickly. Some of these abuses include: enticing the gullible with false and/or deceptive advertising which does not mention the enormous risks present in this game; illegal margin loans which bypass margin limits set by the Federal Reserve, either by loans from the day trading firm itself or, more often, the firm arranging for trader-trader loans to keep one trader's position active though that position may indicate leverage of 90%–or more. Traders who lend, at a potentially profitable percentage, to needy fellow traders are most often not aware that a) they are taking a very grave risk since, if the fellow trader loses, so do they, and b) that they are usually breaking the law.

State regulators have taken the lead in dealing with these problems, as well as the concern that there is improper screening of customers to determine their level of knowledge, and skills, in order to determine their capacities for playing the day trading game.[58] The NASD is the national self-regulating organization for most of the day trading firms, and has proposed that all new customers be adequately screened. The SEC, meanwhile, is conducting examinations of day trading firms to assess their compliance with securities laws and regulations.[59] In addition, the media, society's message bearers, have focused well and often on the day trading phenomenon and its

abuses, to be followed up fully, one can hope, by lawmakers and regulators. If, as many believe, there is a NASDAQ (and, correspondingly, Dow Jones) bubble in the making, when it bursts, many day traders will suffer losses they deserve to pay. But other market investors might well be hurt in the event, lawsuits will proliferate and, overall financial market efficiency may be negatively affected. There are many true professionals who are much concerned about the situation, in particular,

> *that the volatile mixture of high priced Internet stocks, novice investors and buying on margin is so combustible that a shock could spread quickly, through the rest of the market, ruining some investors and jeopardizing the health of some smaller firms…(and) it could also shake the confidence of a generation of fledgling investors…*[60]

Others disagree. While admitting that there is a bubble and it will burst, one Wall Street guru has argued that nevertheless there is a good side to "the voracious appetite for Net stocks" in that they have funneled billions in investment capital into the industry and have maintained the U.S. world leadership in technology. Moreover, he argues, "it is not credible to argue that (day trading) activity poses systemic risk for our markets or our economy."[61]

Of course, severe losses, even to some who are innocent of promoting bubbles, can occur without system breakdown. Any ethical judgement here would clearly depend upon the recognition of all interests at stake and an honest weighing of them in determining how best to proceed, in law and regulation, with day trading and all other manifestations of on line securities transactions.

What is certain is that Internet trading has already made substantial changes in securities markets as we have known them, and that many more are yet to come.

Some of Wall Street's largest and most experienced investment banking houses are moving into Internet operations. They have no choice but to engage in competition with those who can offer ease of access and lower costs through Internet utilization. Merrill Lynch is in the game already.[62] And the competition in trading costs is challenging older methods of broker compensation; e.g., trade-by-trade commissions. Middlemen brokers who wish to maintain high fee structures will have to find ways of delivering value added services, or find themselves unemployed. Now, even apart from

Internet transactions, per trade commissions are giving way to low cost single trades and "asset based advisory fees."[63]

Lower transaction costs and more efficient trading action are, indeed, positive developments brought on by technology and creative imagination. We are still left, however, with the important issue of what ought to be seller-buyer duties and responsibilities in cyberspace transactions. There are, overall, regulatory concerns involving regulator technological sophistication, and manpower and money shortages regarding the enforcement of legal duties. We will return to this problem in Section III. There are already new on line complexities; e.g., who has which duties to uphold in the policing of on line, trading related "chat rooms?" And higher level, old, on the ground concerns such as "pump and dump" operations,[64] and how poor executions can best be dealt with.[65]

The greatest current pending problem (1999) could well be: To what degree of legal duty must an Internet seller be held in terms of "knowing" its customer? The New York Stock Exchange requires that brokers know their clients' overall goals, risk preferences and time horizon before they execute an order, whether they recommend the particular transaction or they do not. This is referred to as the "suitability" rule. NASD holds brokers firmly to a suitability rule when the seller has recommended the transaction, and is considering enlarging the duty to all transactions in cyberspace. To what level of legal duty, exactly, should an on line broker, lacking the normal on the ground client relationship, be held? How well can a seller here "know" the client in terms of what is suitable for her? How about old-line brokers operating in cyberspace as well? Is their level of duty different?

A sizeable percentage of arbitration cases in which customer-buyers prevail are based presently on "unsuitable" investment grounds. In the face of any meaningful market retreat, the ethical and legal issues of "knowing and "suitability" could bring about an intolerable load of damage claims.

It is difficult to contemplate a brokerage firm of any kind making money for themselves in the absence of any duty to act in their clients' best interests and in an informed fashion. But exactly what should regulators require? That on line brokers who open an account ask the kind of questions that illuminate a would be trader's investment

experience and skills before executing any trade? Or set up flashing computer warnings about certain kinds of investing being dangerous to one's financial health?

No broker, in or out of cyberspace, can or should ever be held to a duty to guarantee profits or avoid all losses. Dispensing with all buyer responsibility for his actions would sink our securities markets–and clearly be unethical in any case. Yet is it not outrageous (and publicly unacceptable) to advance the argument that on line duties, and the oversight duty to enforce them, is just too difficult in cyberspace to allow for any seller concern about customers committing financial suicide?[66]

The problem here will be compounded by the reality that stock exchanges themselves are in the process of changing their firms–and possibly their responsibilities. We have reached the stage where a three year old computerized stock trading service (an ECN or "electronic trading network") has applied to the SEC to become a brand new <u>stock exchange</u>.[67] And many other ECNs are waiting in the wings to apply as well. The SEC is studying the issue, but could well grant such an application. In 1999, the SEC rule referred to as "Reg ATS" took effect. It allows alternative trading systems to become stock exchanges. That regulation is focused on the probability that ECNs would be good for market efficiency by dint of rapid innovation and lowered transaction costs.

How should these cyberspace stock exchanges be regulated? And by whom? Themselves as self-regulating organizations? To what duties must they hold themselves? SEC market regulators know the truth of one market exchange expert's recent remark:

This is not a revolution.

It's an earthquake.[68]

In the face of technology developing exponentially how does one keep one's legal and ethical bearings? The editor of a Wall Street magazine put the problem somewhat in perspective:

> *Regulators are having as tough a time as everybody else trying to figure out what their new priorities should be. We all need to move more carefully–There's too much at stake, from the livelihood of market makers to the health of the nation's economy.*[69]

We will discuss confusing priorities in greater detail in Section III. For now, we would conclude by pointing out that the three major established exchanges (NASDAQ and the American Stock Exchange being combined, however) are not unaware of the challenges they are facing. Since ECN financial ownership, currently, comes from sources dependent on NYSE listing and liquidity, that exchange is less immediately threatened than NASDAQ-ASE. Nevertheless, the NYSE is seriously contemplating becoming a for profit company selling its own shares to the public. Their focus is on removing the existing, entrenched power structure which holds back change, and creating a sizeable pool of funds (with which to buy ECNs themselves, perhaps). The NASD is also contemplating spinning NASDAQ off as private for profit company and selling shares to the public as well.[70]

Legislators and regulators seeking to ensure the continued development of the wealth creating function on the one hand, and the fairness and integrity and safety of the markets on the other are faced with a formidable task in a cyberspace with, as yet, indefinable dimensions.

And what weight should the best interests of taxpayers play in decision-making here? It is they who would pay for picking up the pieces in the case of market failure, and the vast majority of them would never have played in the game, or actually understood just what it was.

III. Problems–and Opportunities–In Government Regulation of the Securities Industry

In the U.S. securities industry, where technological advances and risk taking entrepreneurial activity proceed at a pace far ahead of that of any other nation in the world, the regulatory burden is a heavy one. In this section, we intend to approach some overall considerations our securities industry and its regulators must face to carry that burden successfully.

We will not consider specific, existing instruments such as derivatives or securities representing previously untraded assets. And we note here our omission of the issue of globalization of securities markets. We recognize that capital mobility "has all but erased the

line between the domestic and international financial systems" in many transactional areas.[71] Worldwide market connectedness, as we have been reminded through financial crises in other nations, is important.[72] But these realities do not make a focus on keeping our own house in order unimportant. We would argue that how we in the U.S. innovate and regulate will not only be key to the health of our own financial system, but to all others in the world as well.

We begin with a listing of the three general, but crucial, considerations that relate to the coming regulatory task:

1. Technology driven market change has outrun our capacity to comprehend fully the meaning of what has already happened in our securities markets, much less what ought to be happening in the future;

2. We face great difficulties in doing cost benefit analysis regarding individual regulations in the presence of conflicts between efficient market and democratic values being measured in a puzzling present and in the face of an undetermined future.

3. We must continue to deal with the reality of both politician and regulator conflict of interest, and self-regulating organization conflicts as well.

To begin at the beginning: While our regulators do not truly understand the present or future state of securities markets, they must act as if they really did. Questions of fairness, efficiency and safety must be faced since, every day, trillions of dollars, marks, pounds, euros, francs, yen and such continue to change hands in various ways all around the world with some effect, surely, on "the public interest." And in the presence of tremendous numbers of players who feel justified in arguing that public interest is irrelevant to them on the ground that they are playing by the existing rules.

The answer is bound to be advanced: Why worry about regulation, when we can more efficiently leave it to the market to decide what's sustainable and what isn't?

> *Prosperity from free enterprise growth has no need for government…controls. The market itself is the most effective regulator of resources.*[73]

Assisted in times of crisis by lenders of last resort who are, of course, "the government." One need not rely just on the academic definitions of <u>market failure</u>: instability (lag time and perverse reactions); misallocation of resources (monopolies, public goods, externalities and

informational deficiencies)–and all the rest.[74] Beyond the S&L fiasco, and the LTCM debacle in our own country, it has been well pointed out that 80 to 100 countries have faced financial and currency crises since the mid 1970s, 69 of them banking crises. And that does not include transition economics, which would add 20 countries more – clear "evidence of the importance of market failures."[75]

How, then, to proceed realistically in the whirlwind? We suggest utilizing a sensible general approach to working in the face of uncertainty:[76] regulators ought first to examine where current securities markets changes appear to be taking us.

In the direction of rapid institutional and product development, and diffused delivery systems, surely. These create unique opportunities for creating wealth–and for increasing worldwide competition and ever increasing risk.

Fragmented securities markets, say ECNs, must surely point regulators in the direction of "conflicts of interest." Best execution and best price, for example, from a brokerage house owned ECN, may not be forthcoming. That, perhaps, emphasizes the need to consider "which entities should be allowed to own which others" equally with "how best to police conflicts of interests in an unfettered ownership market." One might answer that there's no need to worry about exchange operators since self-regulating organizations and the market itself will take care of all serious funny business. That answer represents, at best, the triumph of hope over experience. A case in point: The NASDAQ point spread, billion dollar scandal. Securities markets failures do not much help to promote our enviable U.S. "equity culture" that can be counted on in both good and not so good times.[77] One might also ask whether a publicly owned NYSE, with self-regulating powers, could be truly dependable and fair to all customers in the face of the Wall Street imperative to make as much money for its owners, right now, as possible without breaking current law?[78]

A useful approach to rule making in the midst of an uncertain future would seem to be to deal meaningfully with the question: What kind of future do we prefer? Perhaps that is oversimplification. However, wherever we're headed, we seem to be travelling there very fast. We would submit that it's less than sensible to make such a speedy trip in ignorance of the destination. We might also want to examine what we do have now in our possession which might help us do our job? That is, What's our leverage here?

Our answer would be our constitutional value system and its concomitant Rule of Law. Among other things, these serve to assure the citizenry that free competitive markets, which certainly encourage wealth creation and personal material well being, encourage liberty and democracy as well. Our trump card is an established culture of public interest protection and it has surely served us well. Other nations around the world, anxious to encourage public trust in their financial institutions, are hard at work trying to understand and emulate that established culture. It won't be easy for them. We must never abandon our value system, not in the face of uncertainty, or even in the service of rapid wealth creation, either. It is our starting point for decision making in the face of uncertainty.

Of course, we must continue to face the reality of conflicting values. One way to do that is to consider cost-benefit analysis. What in fact is the cost of regulating a particular aspect of our commercial and/or public life?

It would be hard to argue against the reality that regulation, in some instances, even in the service of prized values; e.g., clean air, can cost more in some instances than no regulation at all.[79] It would be equally hard, however, to argue against the proposition that effective rules governing securities regulation are "essential to our equity culture";[80] or that a strong Rule of Law means better markets,[81] or that the character and quality of legal rules and law enforcement relate directly to the positive development of capital markets;[82] or that recent financial disasters around the world; e.g., Russia, do drive home the reality that law and regulation supported by the people is one central determinant of progress and the lack of them conducive to destructive instability.[83]

Consideration of the costs and benefits of having very little law and regulation of markets demands a close examination of risks in current markets and the direction in which they are going. Some truly disturbing examples of the existence of too much risk are the failure of LTCM; the uninsured loan for $1.4 billion made by Bank of America to a hedge fund with which it formed a joint trading venture, and which resulted in some $900 million in losses;[84] the horrendous losses of Metallgesselschaft and Barings PLC; [85] the Sumitomo copper trading losses of $2.6 billion and the consequent $25 million in fines paid by Merrill Lynch to the London Metal Exchange and the U.S. CFTC for "aiding and abetting" a client's improper trading in the affair.[86]

The excuse that no amount of risk assessment and internal action could avoid huge losses caused by a determined “rogue broker” are just untrue in the face of the facts. Internal risk assessment failures in every highly publicized case have been detailed, and show that all the “victim” firms failed to do what they should have to avoid their deadly problems.[87] While these examples may, indeed, demonstrate regulatory failures as well, they hardly support a cost benefit argument that rather than expend regulatory dollars, these market players should be left to their own devices.

A joint SEC, NYSE and NASD Task Force, after having made on-site examinations over a period of several years, issued a July, 1999 report sharply critical of brokerage firm risk management in terms of poor supervisory structures, inconsistent use of data and employment of inappropriate risk measurement tools.[88]

We are aware of the existence of many self-defeating regulatory strategies such as inappropriate use of the command-and-control approach and clearly excessive expenditures that could have been avoided by determinable cost benefit analysis; e.g., the $632 billion spent on pollution control between 1972 and 1985.[89] Nevertheless, costs and benefits are not so clearly determinable in the case of valuing “risk” properly, and certainly valuing “continued confidence” in securities markets, whether the regulatory focus be on derivatives, capital requirements for securities firms[90] or insider trading. We would risk erring on the side of regulatory action and proper expenditure, investor confidence, and less reliance on the use of the court system to redress market failures.

The leverage necessary for firm regulatory guidance in the public interest is threatened by the high inefficiency and unfairness costs imposed on the regulatory process by both questionable politics at the lawmaker level, regulator conflicts of interest and self-regulating organization turf wars.

A refusal by legislators to pass effective enabling legislation and/or to fail to authorize and then appropriate sufficient funds to allow regulatory bodies to do their jobs is an ever-present concern. Legislators may do these things out of determined political beliefs, which is their right and obligation. However, it all too often appears that these refusals to pass laws and failures to authorize funding for regulators is uncomfortably connected to politicians’ sources of

campaign funding. Proper regulatory leverage must unfortunately take cognizance of the problem of lobbyists, PACs and much criticized forms of campaign financing.[91]

This reality encourages a regulatory concern raised by advocates of an economic theory which holds that regulations are the result of private parties seeking their own personal benefit or the deprivation of benefits to others. Regulation in this view is solely the result of self-interest and disparities in political influence.[92]

Clearly, some regulation (or lack of it) springs from that source. Clearly some regulation does not. Two good examples would be the Federal Sentencing Guidelines Chapter 8, and the Toxic Release Inventory which requires the annual filing by corporations of toxic chemicals released into the air by their operations. The Inventory not only passed despite enormous industry opposition, it was denounced by the President himself.[93]

Regulations are often judged as self-serving by citing their consequences. As others have pointed out, that is simply bad social science. What is necessary to any argument into the origin of legislation "is careful investigation into the actual forces which led to specific legislation (and) regulation (and) such investigations are infrequent."[94]

Substantive change in our campaign financing laws has proved to be a non-starter in a self-interested Congress. More regulator and public cooperation supported by a responsible media might help to alert the public of the dangers to them of legislative inactivity. And an alert and caring public is the only real antidote to legislator self interest.

Of course, to rally regulatory bodies and regulators to a cause means getting past <u>their own</u> conflicts of interest.

To state that in the SEC no regulators are truly motivated to act in the public interest would not be simply insulting, but preposterous as well.[95]

Yet to deny any regulator misfeasance, malfeasance and nonfeasance and the lack of ethical behavior those would indicate, would be ingenuous at best. How regulators themselves might be more effectively and efficiently monitored and, when necessary, disciplined, is a subject demanding serious analysis. Insights into how best to align regulatory incentives with those of taxpayers are clearly needed. Failures in effective commercial banking legislation connected to the S&L disaster gives support to financial agency theory that would connect

taxpayer losses to unresolved conflicts of interest between government regulators (and politicians) and the taxpayers.[96]

Professor Kane suggests that whether we focus on high paying jobs awarded to regulators as soon as they leave the regulatory body, or any other manifestation of conflict of interest, news organizations and academic researchers could do much to improve the "intellectual level of public debate about financial supervision and regulation in the United States…(since it) is embarrassingly low."[97]

To the government regulator conflict of interest must be added another problem hampering safety and efficiency, and that is institutional infighting.

> *Turf battles, overlap, and duplication remain under scrutiny, with an SEC task force considering how to improve relations with self-regulatory organizations, such as the National Association of Securities Dealers; criminal authorities; states, and other agencies.*[98]

The SEC and the Chicago Board of Trade fought a bitter battle over the issue of whether to allow CBOT offerings of futures contracts based on the Dow Jones utilities and transportation stock indexes. The CBOT's fight was to gain parity with the Chicago Board Options Exchange and Japanese and Australian and other foreign futures markets. The SEC's expressed concern was focused on possible conflicts of interest. A 3 judge panel found in favor of CBOT expansion.[99]

States, too, may begin to encourage financial institutions to spread their wings and fly beyond the federal regulator playing field. The Governor of New York has proposed a bill to his legislature that would alter the state's banking charter. Firms would be able to do commercial banking, and to underwrite and sell insurance and securities. This would be good for the new Citicorp-Travelers combination which faces mandated divestitures under Federal Reserve oversight. And giant investment banks could conduct retail banking operations through an affiliated thrift charter. Of course, commercial banks would have to give up their federal charters and we would see a shift in primary regulators.[100]

Finally, self-regulating organizations have, of late, shown disturbing weaknesses. In addition to the NASD lapse in connection with the billion dollar NASDAQ point spread scandal, 1999 saw the securities industry's number one SRO–the New York Stock Exchange–publicly chastised for oversight failures. What the NYSE missed was the existence of illegal trading on

the floor of the exchange. Floor brokers executing orders in an account, were allegedly sharing profits from that account as well. Four NYSE floor brokers also pleaded guilty in a federal court to a conspiracy to place trades to benefit themselves and not their customers. The result of an SEC investigation was the institution, by the NYSE, of several new regulatory initiatives, including a system that will enable the exchange to reconstruct any trade or cancelled trade from beginning to end.[101]

It does not belittle the generally careful and laudable oversight of the NYSE and the NASD, to note the possibility that when oversight problems do arise, they could be related to an overly protective watcher stance with a bit too much regard paid to the interests of the watched rather than their customers. Some traders even alleged that the NYSE had known for some time that some brokers were sharing profits with a client and had let the matter pass.[102] One wonders whether stock exchange SROs will become stronger or weaker in their oversight duties when (and if) they become an arm of a profit making institution.[103]

The Federal Reserve and the SEC began a battle over the issue of commercial bank loan loss allowances in the fall of 1998. The SEC, while engaged in its ongoing initiative to address the problem of earnings manipulation in a number of industries, became critical of some banks' loan loss reserve practices. One banking organization was ordered to reduce its reserves by $100 million, and other banks became concerned. So did the Federal Reserve which had determined that issue for the banks in its charge on the basis of what it perceived as best for safety and soundness.

A Joint Working Group of banking agencies and the SEC was formed to deal with the issue of correlating safety and soundness requirements with financial statement and report earnings transparency.[104] The resolution seems to make good sense; however, it is a bit unsettling to see the two major financial system regulators going head to head on a serious public interest issue.

Should the Glass Steagall law establishing commercial bank/investment bank separation be repealed, one concern must be who will regulate whom, and why? This is as much a socio-political matter as it is a purely regulatory one. One can only hope that the best interests of the public will be the legislative goal. And that any input from the regulatory leadership will not focus primarily on their own turf interests or on the interest of their charges, the commercial

banks and the investment banks and brokerage firms. Rather they should respond in the interests of their principals, the people.

IV. A Somewhat Broader Conclusion

Financial markets will surely merit the attention of government regulation and law in the new century now almost upon us. We have attempted in this paper to delineate some of the legal and ethical issues raised by financial market activities and those institutions with oversight of them. But we would end this paper with a broader reflection on the essential role government will have to play in the ethical behavior of corporations in the immediate decade to come.

We must focus very clearly and very soon on the many complex issues raised by the coming of the genetic revolution. Many free competitive markets, financial markets certainly being among them, will be involved in such activities as genetic testing for predisposition to serious illnesses, gene therapy, and genetic engineering encompassing everything from the choice of physical and perhaps mental characteristics of one's offspring, to the act of cloning humans. Finance and economics, science and religion will demand policy decisions affecting these markets which will require a kind of involvement of law and regulation beyond anything ever dreamed of as little as 50 years ago.

How we as a society resolve the ethical "ought tos" (and ought not tos) involved in coming markets could go very far indeed in determining not just the financial and economic, but the moral shape of humanity as well in the 21st century and beyond.

Surely we all have to hope that the lawmakers, regulators and corporate leaders involved in all of these 21st century markets will be represented by men and women with ethical sensitivities of the highest order. And with the will and the skill to incorporate them into their market and oversight actions, and in the public interest.

[1] Testimony before the Committee on Banking, Housing and Urban Affairs of the United States Senate, November 27, 1995.
[2] The Securities Acts of 1993 ("Truth in Securities Act") and the Securities Exchange Act of 1934.
[3] Regulator responsibility is a subject of enormous importance, not sufficiently related to academia. One who has done so both forcefully and well is Edward J. Kane, "Ethical Foundations of Financial Regulation," Journal of Financial Services Research 12:1 51–74 (1997). We will refer to some aspects of the regulator role in this paper, but hardly in as substantive a manner as does Professor Kane.
[4] We have done so, albeit briefly, and at the level of the lay reader, in Bear/Maldonado-Bear, Free Markets, Finance, Ethics and Law, pgs. 93–100 (Prentice Hall, 1994).
[5] Even with Federalist backed cooperation on amendments, the Constitution was barely accepted in Massachusetts (187–168), Virginia (89–79) and New Hampshire (57–47)–to name but three of the discontented thirteen colonies. See Bear/Maldonado-Bear, note 4 supra, at 94.
[6] With one important exception: the abandonment of the original concession to slavery–a value well disposed of, and specifically replaced by the prohibition of slavery (13th Amendment, 1865), and the protection of basic constitutional rights in the face of any state attempt to abridge or deny them (14th Amendment, 1868).
[7] Steven H. Gifis, Law Dictionary, 3rd edition (Barons, 1991), page 82, citing the judge in 37 N.W. 2d 543, 547.
[8] For example, Congress has never defined "insider trading," leaving it up to the SEC and the courts to define it within the broad, statutory limits.
[9] 12 U.S.C. Sec 1843 (c) (8).
[10] A recent example of Federal Reserve decision making under Sec. 4 of the Bank Holding Co-Act is to be found in "Order Approving Notice to Conduct Certain Data Processing and Other Non-Bank Activities," Federal Reserve Bulletin, pages 582-586 (August, 1999) (permission granted to 14 Bank Holding Companies to buy jointly two electronic funds transfer networks).
[11] George Soros, The Crisis of Global Capitalism (Open Society Endangered) (Public Affairs, Perseus Book Group, 1998) pages 196-197.
[12] Q. Kip Schlegal, Just Desserts for Corporate Criminals (Northeastern Univ. Press, 1990) esp. Chapter One.
[13] Bear/Maldonado-Bear, note 4, supra at page 408.
[14] Public Law 98-473, now codified in various sections of 18 U.S.C. and 28 U.S.C. (1988).
[15] Bear/Maldonado-Bear, note 4, supra at pages 406-407.
[16] Mistretta v. U.S., 109 S.Ct. 647 (1989).
[17] The Sentencing Guidelines Manual, Section 8, intro. cmt. (1998). "Organizations" is defined as including every possible combination: corporations, partnerships, unions, trusts, pension funds, etc.
[18] from The Merrill Lynch Principles, reprinted in John L. Casey, Values Added: Making Ethical Decisions in the Financial Marketplace (University Press of America, 1997) pages 232-235. See also for corporate culture's clear effect upon the actions of individuals functioning within it: Robert Jackall, Moral Mazes: The World of Corporate Managers (Oxford Univ. Press, 1988).
[19] Sentencing Guidelines, note 17, supra at Section 8A1.2, "Commentary" and section 3(K)1-7(iii), "Application Notes.
[20] See Kaplan et al., Compliance Programs and the Corporate Sentencing Guidelines (Clark, Boardman, Callahan, 1994 at section 3.19).
[21] From the authors' personal contacts with U.S. Government officials attached to the Securities and Exchange Commission, the Office of the U.S. Attorney for the Southern District of New York and the Division of Procurement of the Navy Department.
[22] Kaplan et al., "Living With the Organizational Guidelines," Buchanan et al., Cases and Materials In Markets, Ethics and Law (Simon and Schuster, 1998). See also: Lynn Sharp Paine, Cases In Leadership, Ethics and Organizational Integrity (Irwin, 1997) at pages 91-97.
[23] That's right. Insider Trading is a crime even if you lose money doing it.
[24] United States v. O'Hagan, 117 S.Ct. 2199 (1997).
[25] Sentencing Guidelines, note 17, supra at section 8C2.5, comment (note 12).
[26] L. Himmelstein, "When the Company Becomes a Cop," Business Week, June 6, 1994; D. Starkman, "Pollution Case Highlights Trend to Let Employees Take the Rap," the Wall Street Journal, October 9, 1997.
[27] See J. Gibeaut, "Getting Your House In Order," American Bar Association Journal, June, 1999, esp. at pages 68-69. Recent examples of corporate culture weaknesses resulting in serious financial and reputational damage are Salomon Brothers' treasury auction debacle (they are no longer independent); Sears Roebuck (so far, allegations of

misleading practices have cost them $646 million, and lawsuits are still pending); Prudential (where allegations of various misleading practices over a 12 year period has cost $2.658 billion dollars); and others, including firms who had to pay $1.1 billion to settle allegations of unfair NASDAQ market manipulation. See J.B. Cahill, "Sears is Sued Again on Auto Center Work," the Wall Street Journal, June 17, 1999; B. O'Brien, "Prudential Fined $20 Million by NASD Over Its Sales of Variable Life Insurance,: the Wall Street Journal, July 9, 1999; D. Lohse, "Robertson Firm Is Last to Settle a NASDAQ Case," the Wall Street Journal, March 24, 1999. For a blow by blow description of the Pru-Bache corporate culture at work, see Kurt Eichenwald, Serpent on the Rock (Harper Business, 1995). It is difficult to quantify specifically, but not to observe generally, the costs of these disasters to corporate reputation, not just externally to the public, but internally to the workforce as well.

[28] 29 CFR Section 1604.11. Paragraphs A-E deal specifically with sexual harassment as a violation of Title VII (Civil Rights). Sexual harassment is no stranger to Wall Street; e.g., The Smith Barney "Boom Boom Room." See P. McGeehon, "Smith Barney Moves Toward Sex Bias Accord," the Wall Street Journal, August 19, 1997.

[29] Burlington Industries v. Ellenth, 188 S.Ct. 2257 (1998) and Farragher v. City of Boca Raton, 118 S.Ct. 2275 (1998).

[30] If a preventive and corrective program was in truth no more than paper with words on it, hardly ever adhered to, a refusal to "utilize" it would not be "unreasonable."

[31] Kimsey v. WalMart Stores, Inc., 107 F. 3d 568 (8th Circuit, 1997).

[32] M. Siconolfi, "Underwriters Set Aside IPO Stock for Officials of Potential Customers," the Wall Street Journal, November 12, 1997.

[33] For more on fiduciary duties see: Bear/Maldonado-Bear, note 4, supra at 186-208.

[34] See note 7, supra

[35] All quotes are contained in M. Siconolfi, "Massachusetts Nears Pact in IPO Probe," the Wall Street Journal, December 3, 1998.

[36] J. Taylor, "SEC Wants Investment Managers to Tell Clients More About 'Soft Dollar' Services," the Wall Street Journal, February 15, 1995.

[37] C. Gasparino, "SEC to Alter 'Soft Dollar' Disclosures," the Wall Street Journal, July 10, 1998. The figure of $5.5 trillion for Mutual Funds can be found at page 1 of the Mutual Fund Factbook, 39th edition, 1999.

[38] The old really restrictive section 13(3), allowing some access to Fed loans by non bank financial firms was amended to make that loan process easier by Section 473 of FDICIA.

[39] "Alan Greenspan Testimony to the House of Representatives Committee on Banking and Financial Services, October 1, 1998," Federal Reserve Bulletin, December, 1998, pages 1046-1050.

[40] Note 39, supra. By mid September, 1998, LTCM's equity had dropped by $4 billion, and it was on September 22 that the Fed helped set up a 16 member committee to bail LTCM out. The committee was more or less evenly divided between investment and commercial banks. See F.R. Edwards, "Hedge Funds and the Collapse of Long Term Management," Journal of Economic Perspectives, Spring, 1999 at pages 189-210, esp. at page 200.

[41] F.R. Edwards, note 40, supra.

[42] R.W. Medway, managing partner of Royal Capital Management, in "Hedge Funds Are Really Mild Mannered," the Wall Street Journal, "Letters to the Editor," October 9, 1998.

[43] See Lehnert and Passmore, "The Banking Industry and the Safety Net Subsidy," Finance and Economic Division Series, Divisions of Research and Monetary Affairs, FRB, 1999-34.

[44] The figures are from a table prepared by Gretchen Morgenson in her article, "Humbled By the Company He Kept," the New York Times, July 4, 1999.

[45] R. Smith, "Bear Stearns Could Settle Clearing Case," the Wall Street Journal, June 23, 1999.

[46] The Bear Stearns story is fully and dramatically detailed in Morgenson, note 44, supra.

[47] M. Siconolfi, "Heat Rises On Wall Street 'Clearing Operations'," the Wall Street Journal, June 17, 1997.

[48] M. Siconolfi, "Bear Stearns Takes Stand On Clearing," the Wall Street Journal, September 26, 1997.

[49] G. Morgenson, "School For Wall Street Scandal," the New York Times, August 8, 1999.

[50] C. Gasparino, "Bear Stearn's Richard Harriton Is Likely To Step Down as Part of Pact with SEC," the Wall Street Journal, July 7, 1999. Mr Harriton has also issued a public defense of his actions based on two arguments: 1. He was playing by the (then) rules and there's nothing wrong with that, and 2. The SEC also knew Baron was doing wrong and they did nothing, either, encouraging him to remain as Baron's clearing firm. See "Fraud at Bear Stearns? Two Views," the Wall Street Journal, September 1, 1999 at page A26. 1. Is not likely to help him much, but 2. is interesting if it's 100% accurate.

[51] Richard F. Syron (then Chairman and CEO of the American Stock Exchange), "Ethical Imperatives for Stock Markets in the New Millenium," (Center for Business Ethics, Bentley College, February 8, 1999).

[52] See, for example: R. Salbu, "Who Should Govern the Internet: Monitoring & Supporting a New Frontier," Harvard Jnl. of Law & Technology, Vol. 11 #2, Winter, 1998.

[53] D.B. Henriques, "Testing an Emerging Market," the New York Times, May 12, 1999, offers the Securities Industry Association, Credit Suisse First Boston and the SEC as sources for her figures; R. Buckman, in "Firm Pegs Accounts in On Line Trading," at 3.7 million, the Wall Street Journal, March 25, 1999 cites Forrester Research for her figures. In her story, however, another analyst is cited as using the figure of 7.3 million on line accounts with Charles Schwab and Fidelity Investments claiming 5.5 million just between them. I.J. Dugan's "Bitten By the Bull Market in the Washington Post Weekly Edition, February 8, 1999, claims that "one out of 4 trades is executed on line." The bottom line seems to be that nobody seems to know for sure exactly how many on line accounts exist, or how much total trading (money) they account for–But one answer surely must be: a lot!
[54] "The On Line Lineup," in the special Wall Street Journal supplement: "On Line Investing," June 4, 1999. The 10 trading firms, listed in order of market share, from 27.9% for #1 to 1.3% for #10 are: Charles Schwab; E*Trade; Waterhouse Securities; Datek Securities; Ameritrade; DLJ Direct; Discover Brokerage Direct; Suretrade; and National Discount Brokers. Ibid.
[55] See "Lehman, Other Firms Join Ranks of Settlers With Orange County," the Wall Street Journal, page A6, June 9, 1999.
[56] I.J. Dugan, note 53, supra.
[57] R Buckman, "Probe of Day Trading Companies Finds 75% of Accounts Surveyed in the Red," the Wall Street Journal, August 9, 1999. Mark O. Barton, who slaughtered 12 people in Atlanta, Georgia late in July 1999, had lost $505,000 day trading and had received a margin call to put up more money two days before he killed his wife and children and shot some day trader colleagues. His case is not proof that day trading can lead to mass murder, given Barton's personal history. However, it would be hard to argue that his dreadful acts could not be linked in any way whatsoever to his personal day trading experiences.
[58] A major report on day trading was issued in August, 1999, by the state's North American Securities Administrators' Association. See: M. Schroeder, "Day Trading Firms Rebuked by Group of State Regulators Over Marketing," the Wall Street Journal, August 10, 1999.
[59] Ibid.
[60] R. Buckman and A. Lucchetti, "Wall Street, Fearing Internet Stock Bubble, Prepares for the Pop," the Wall Street Journal, February 24, 1999.
[61] B.J. Malkiel, "Day Trading and Its Dangers," the Wall Street Journal, August 3, 1999. Of course, it should be pointed out, from the ethical point of view at least, that one reason why "systemic risk" might be avoided is the presence of the implicit guarantee that "if stock prices collapse, the Greenspan Fed will lower interest rates and feed money to bankers to keep credit–and the economy–from 'seizing up'," L. Uchitelle, "Finding the Steam Value in an Overheated Market," the New York Times, September 5, 1999. Some free marketers might refer to such Fed intervention as helping to maintain faith in a free market's ability to correct its own shortcomings. Others might more readily admit to the existence of a market failure, with government "interference" necessary to its correction.
[62] And with a bang. Merrill has introduced "Unlimited Advantage" with financial planning and "virtually unlimited" trading on the net. See its 3 page advertisement at pages A11, 12 & 13 of the Wall Street Journal, July 14, 1999.
[63] Id. Prudential has bid to "revolutionize full service brokerage" by phasing out transaction by transaction commissions. See Business Section, New York Times, May 23, 1999, page 3. Of course, the brokerage houses are only one step ahead of the regulators who are proposing new rules to curb conflict of interest incentives to brokers (e.g., prizes for "the producer of the month") and higher commissions for selling in-house products. Broker compensation is clearly in for substantive revision. See R. Smith, "Regulatory Arm of NASD Proposes Rules on Incentives," the Wall Street Journal, September 8, 1999.
[64] "Pump and Dump" refers to the situation where on line touts, either through exaggeration or outright lies, pump in the sort of information which makes a stock look like a sure big winner, then dump it for a profit when suckers' buying has pushed it up.
[65] Actually, on line traders are sometimes paying as much or more, in the end, as they would have to pay to an on the ground commission broker. Here is the possible problem: Assume an on line purchase order for 100 shares of Widget stock. By the time the electronic order is filled, the stock might be up $1 over the price the buyer assumed he'd pay at the very moment he put it in. That's $100 added to the "low" on line commission. See Ip and Buckman, "Regulators Worry That On Line Investors May Be Getting Poor Trade Executions," the Wall Street Journal, April 23, 1999.
[66] An interesting article in this general area is Simon and Buckman, "Can Brokerage Advice and Internet Mix?" the Wall Street Journal, April 23, 1999.
[67] The applicant is Island ECN. Some 19 other ECNs are waiting in the wings! Including a "super ECN" formed by a Bloomberg subsidiary and ITG. An excellent examination of the fast changing stock markets landscape is G. Ip, "Trading Places," the Wall Street Journal, July 27, 1999.

[68] Professor Robert A. Schwartz, quoted in D.B. Henriques, "Testing An Emerging Market," the New York Times, May 12, 1999.
[69] John Byrne, editor of The Trader, quoted in D.B. Henriques, note 68, supra.
[70] G. Ip, note 67, supra. See also: A. Sloan, "A Long Season of Wall Street Weirdness, Newsweek, September 13, 1999
[71] B. Eichengreen, "The Global Gamble On Financial Liberalization: Reflections On Capital Mobility, National Autonomy and Social Justice," Ethics and International Affairs, Vol. 13, 1999 at page 216.
[72] See for example, R. Dornbusch, "After Asia: New Directions for the International Financial System," in Beyond Shocks, FRB of Boston Conference Series No. 42, 1998.
[73] L. Kudlow, "What's More Important Than the Fed?" the Wall Street Journal, August 27, 1999.
[74] See Bear/Maldonado-Bear, note 4, supra at pages 58-63.
[75] J. Stiglitz, "Reforming the Global Economic Architecture," the Journal of Finance, August, 1999 at pages 150,154.
[76] Barry B. Hughes, International Futures: Choices in the Face of Uncertainty (Westview, 3rd edition, 1999).
[77] And only in the United States, among the major industrial nations, has an "Equity Culture" thus far been fully developed. See D.M. Jones, "Fed Policy, Financial Market Efficiency, and Capital Flows," the Journal of Finance, August, 1999 at pages 1506-1507. An interesting example is a Japan-USA comparison. In August, 1999, individuals in Japan accounted for 16% of trading on Japanese exchanges and stocks made up 10% of their assets, including mutual funds. In the "equity culture" of the United States, individuals hold some 60% of their assets in stocks directly or through mutual funds. See: B. Spindle "Japan's Broker Commissions Are Discounted," the Wall Street Journal, September 8, 1999. Perhaps the October 1, 1999 "big bang" in Japan will make some difference (lower commissions); however, we would guess that the key element necessary for substantive change in individual investor psychology in Japan is Trust. See, generally, LaPorta et al., "Trust in Large Organizations," American Economic Review, May, 1997 at 333-337.
[78] See G. Morgenson, "Not to Seem Cranky, But What's the Big Rush?" the New York Times, August 9, 1999.
[79] A succinct evaluation of regulation in the environmental arena can be found in Cass R. Sunstein, Free Markets and Social Justice (University of Chicago Press, 1997), esp. at Chapter 10.
[80] Jones, note 77, supra at 1507.
[81] Frye and Shleifer, "The Invisible Hand and the Golden Hand," American Economic Review, May 1997.
[82] Shleifer et al., "Legal Determinants of External Finance," the Journal of Finance, July 1997. See also, relative to problems raised by incongruent legal and financial structures in the European Union, particularly with regard to shareholder and creditor rights: S.G. Checcetti, "Legal Structure, Financial Structure and the Monetary Policy Transmission Mechanism," FRB of New York Economic Policy Review, July, 1999.
[83] One notes the despair of the Chief Judge of the Supreme Court of Venezuela who resigned in the face of her own Court's decision (over her objection) that the Venezuelan Assembly had the legal right to designate to itself the power to fire judges and to overhaul the nation's court system. So much for the separation of powers. See: "Chief of Venezuelan Court Quits to Protest Ruling," the Wall Street Journal, August 26, 1999 at page A13.
[84] F.R. Edwards, note 40, supra.
[85] See: A. Kuprianov, "Derivatives Debacles," FRB of Richmond Economic Quarterly, Fall 1995.
[86] P.A. McKay, "Merrill Lynch Agrees to Pay $25 Million in Fines," the Wall Street Journal, July 1, 1999.
[87] F.R. Edwards, note 40 supra, and A. Kuprianov, note 85, supra. See also the embarrasing story of how a single broker circumvented Merrill Lynch compliance in D. McDermott and S. Webb, "How Merrill Lynch Wished Upon a Star Banker and Wound Up In a Singapore Sling," the Wall Street Journal, May 21, 1999.
[88] "Task Force Faults Brokerage Firms' Risk Management," the Wall Street Journal, July 30, 1999, page B5A.
[89] See Sunstein, note 79, supra at pages 274-275.
[90] See e.g., Dimson and March, "Capital Requirements for Securities Firms," the Journal of Finance, July 1995.
[91] In the first half of 1999, "soft money" donations from interest groups (led by the telecommunications and the securities and investment industries), into political party coffers was up 80% over the first half of 1998, P. Kuntz, "Soft Money Donations to Both Parties Hit Record Account Ahead of Elections," the Wall Street Journal, August 31, 1999.
[92] Professor Sunstein does not subscribe to this view. However, he well points out that regulatory agencies are responsive to shifts in political opinion, and even to the views of the President. And worse, that the "independent" agencies have "generally been highly susceptible to the political presence of well organized political groups." Note 79, supra at page 285.
[93] The "Right-To-Know" Law is contained in Title III of the 1986 Superfund Amendments and the Re-Authorization Act (SARA). For a brief history of the battle see: Bear/Maldonado-Bear, note 4, supra at page 149.
[94] Sunstein, note 79, supra at page 288.

[95] See for an example of laudable regulatory performance: J. Burns, "SEC Enforcement Division Earns High Marks for Speedup in Past Year," the Wall Street Journal, July 23, 1999.
[96] Professor Kane's seminal article, "Ethical Foundations of Financial Regulation," note 3, supra is the most fully developed presentation of regulator conflict of interest concerns that we are aware of. It deserves a close reading. We note here Professor Kane's names for, and description of, the 5 key dysfunctional propensities of regulators: The Ostrich Reflex, the Trust-Me Reflex, the Cover-Up Reflex, the Distraction Reflex, and the Guilt-Shifting Reflex! Note 3 supra at page 65.
[97] Id at page 67.
[98] Note 95, supra.
[99] P.A. McKay, "Court Win Over Regulators May Allow Commodities Exchange More Freedom," the Wall Street Journal, August 13, 1999. The SEC could appeal this decision. And for a disturbing picture of internecine warfare in the nation's option exchanges, see: S.M. Sears and P.A. McKay, "Options Duel Over Listings Prompts Concerns on Prices," the Wall Street Journal, September 1, 1999.
[100] "New York May Give Some Financial Firms Operational Leeway, the Wall Street Journal, May 7, 1999, page B6.
[101] G. Ip, "Big Board, SEC Reach Settlement," the Wall Street Journal, June 6, 1999, and Ip and Shroeder, "SEC Assails Oversight Lag at Big Board," the Wall Street Journal, June 30, 1999.
[102] Ip and Shroeder, note 101, supra.
[103] See: G. Morgenson, note 78, supra.
[104] See the "Statement by Lawrence H. Myer, member of the Board of Governors of the Federal Reserve System before the Sub-Committee on Financial Institutions and Consumer Credit, of the Committee on Banking and Financial Services, U.S. House of Representatives, June 16, 1999. Federal Reserve Bulletin, August, 1999.