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Lessons for Today by the Deregulation of Yesteryear: Analyzing Modern Capital Market Deregulation with Historical Examples

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Abstract

Financial market regulators in the US have proposed cutting down their own rulebooks in recent years. However, when it comes to deregulating modern capital markets, the outcomes of historical alterations of similar natures should serve as lessons in what works and what doesn't. This comment analyzes three modern-day proposals to deregulate US financial markets, using historical actions to argue for the likely efficacy of each.

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"*The four most expensive words in the English language are 'this time it's different'.*"[2]

INTRODUCTION:

Modern capital markets are one of the most sophisticated and rapidly evolving areas of American society; yet, the most valuable lessons on deregulatory prudence are still taught by history's successes and failures. Since 2017 however, those lessons have gone largely unheeded and unmentioned as capital market regulators in the US have rushed to rewrite, and even erase, parts of the rulebook. Three deregulatory modifications, as proposed in 2020, have the potential to change the future landscape of markets for decades to come. Given the uncertain results of each, I argue that we should listen to what historical examples of deregulating markets have to say for clues in assessing how prudent today's newborn proposals really are.

The objective of this comment is to discuss the likely efficacy of three modern-day proposals to deregulate certain aspects of capital markets in light of historical deregulation actions. It is important to note that the analysis herein aims not to prove that capital market deregulation is some sort of golden lever for financial growth and prosperity, nor that it is an evil method of loophole creation that will lead to our collective downfall. Rather, it aims to show the collective idiocy of such absolutism by bringing circumstances and catalysts together with both intended and unintended consequences to show that the devil truly is in the details when it comes to capital market deregulation.

The comment is broken down into four parts. Part 1 provides background on capital markets and their regulators before explaining the

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2 WILLIAM BERNSTEIN, THE FOUR PILLARS OF INVESTING: LESSONS FOR BUILDING A WINNING PORTFOLIO (2002) (McGraw-Hill., 1st ed. 2002) (quoting Sir John Marks Templeton).

basic economic theories behind regulation and deregulation. Part 2 introduces three deregulatory proposals and their respective objectives and rationales. Following that outlay, Part 3 digs into a handful of historical instances of financial market deregulation for what was changed, why it was done, and what it led to. Finally, utilizing those historical lessons, Part 4 argues the likely efficacy (or lack thereof) of today's trio of deregulatory proposals.

PART 1: FINANCIAL MARKETS & THE SCIENCE OF REGULATION

" . . . by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention."[3]

The theoretical function of today's financial markets is almost conceptually identical to the role of markets that Adam Smith wrote of nearly 250 years ago. The purpose of modern financial markets is to allow capital to be directed to its most productive use in an efficient manner.[4] Not to be oversimplified however, an endless number of not-so-invisible factors play into the operation of modern capital markets, often wielding nothing more than the overconfidence of an overpriced tucked-in shirt. And while modern capital markets create tremendous tangible benefits, such as information aggregation, price determination and risk diversification,[5] they are not without the occasional harsh reality of those ends which were never intended.

1.1 – Markets & Their Keepers

Public and private capital markets are essentially the same game being played in a different arena under different rules. They operate differently and offer respective advantages and disadvantages for issuers and investors. Public markets here in the US are found on exchanges such as the New York Stock Exchange (the "***NYSE***"), Nasdaq, and Chicago Mercantile Exchange that accept offers to buy and sell from the general public by way of brokers. Due to regulated disclosure requirements, public equity markets are arguably far more transparent and efficient, while

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3 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, Volume 1, Book 4, Chapter 2 (Project Gutenberg, 2009) (1776) (ebook).

4 *See* JUKKA GRONOW, DECIPHERING MARKETS AND MONEY 132-34 (Helsinki University Press, 2020).

5 Leigh Tesfatsion, *Introductory Notes on Financial Markets*, (Mar. 5, 2012), http://www2.econ.iastate.edu/tesfatsi/finintro.htm.

typically carrying lower chances of undisclosed risk than their private counterparts.[6] And with the help of ever-evolving technology, US public markets offer greater degrees of liquidity than private markets by providing a forum where securities can change hands in milliseconds during open trading, which is generally available at least 250 days a year.

Private markets on the other hand are far more amorphous. The term "private markets" usually refers to the non-public exchange of rarely or never traded securities which stretches beyond mainstream stocks and bonds.[7] However, in reality, private markets are the forum where stocks, bonds, and other investment vehicles are bought and sold between parties consenting to price discovery on a micro level rather than publicly traded. While the lack of liquidity is an obvious drawback on private market investment framework, the capability to produce returns far above and beyond those typically realized in public markets maintains a steady demand for private securities. In fact, since 2009 the amount of capital raised in private exempt offerings has exceeded the amount raised through registered offerings in every single year—by at least $500 billion each year.[8]

Federal law, however, generally limits access to these markets.[9] Elected federal officials and administrative agencies share responsibilities for regulating and overseeing public and private markets. While the United States Securities and Exchange Commission (the "***SEC***" or "***Commission***") is the principal regulator of our largest capital markets, both the legislative and executive branches also play significant roles in the traditional regulatory framework. Originally created by Roosevelt's New Deal in the shadows of the Great Depression, the SEC has three main missions in its regulatory role today: **(1) protect investors; (2) maintain fair, orderly, and efficient markets and (3) facilitate capital formation**.[10] To carry out its missions, the SEC regulates the key participants in securities markets to promote the disclosure of important market-related information in order to maintain fair dealing and protect against fraud amongst them.[11] Additionally, the United States Treasury Department, the Board of Governors of the US Federal Reserve (the

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6 *See* Alex Browning, *The Rewards of Private Equity's 'Unrewarded' Risks*, CALLAN (July 12, 2017), https://www.callan.com/private-equity-risks/.

7 Robin Wigglesworth, *Private versus public markets is the battle to watch*, FIN. TIMES (Feb. 8, 2019), https://www.ft.com/content/7ce1ee52-2b0e-11e9-88a4-c32129756dd8.

8 *Id.*

9 *See id.*; *see also Private Equity Funds*, U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/basics/investment-products/private-equity-funds.

10 *What We Do*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/Article/whatwedo.html (last modified Dec. 18, 2020).

11 *See id.*

"***Fed***"), and Commodities Futures Trading Commission (the "***CFTC***") serve ancillary, yet vital, regulator roles.

1.2 – Theory of Regulation & Deregulation

Since federal supervision of financial markets began, observers have questioned whether regulatory actions actually benefit the market participants as anticipated or further the intended objectives.[12] Those questions can be asked within the context of both the addition and removal of capital market restrictions. Regulation is often viewed as merely creating economic costs in order to maintain certain authoritative controls. However, such simple-minded analyses fail to see the whole picture. In reality, regulation typically provides certain qualitative benefits to capital markets as a whole, such as an informed investor base, improved liquidity, and decreased losses to fraud.[13] Think of gasoline taxes for a useful analogy. While imposition of a tax on fuel obviously creates added economic costs, the cost-benefit analysis can't end there. The qualitative benefits of having roads to drive on or bridges that are maintained provide the harder-to-quantify second half of that equation. Deregulation should be examined in a similar, but reverse fashion.

In general, regulation is "one of the small number of major ways by which governments seek to control or mold social and individual conduct."[14] In connection to capital markets, two of the most common justifications for regulation are influencing resource allocation and maintaining economic stability.[15]

Additionally, disclosure and due diligence are the foundational concepts of securities regulation.[16] The function of due diligence is to provide the public with the relevant information that is then reflected in the market price of securities.[17] "The disclosure philosophy of securities regulation works because it puts decision-making power in the hands of

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12 Marcia M. Cornett, Wallace N. Davidson & Nanda Rangan, *Deregulation in investment banking: Industry concentration following Rule 415*, 20 J. OF BANKING & FIN. 85, 100 (1996).

13 *See generally* Sam Peltzman, *The Economic Theory of Regulation after a Decade of Deregulation*, BROOKINGS PAPERS ON ECON. ACTIVITY (1989).

14 Robert B. Horwitz, *Understanding Deregulation*, 15 THEORY & SOCIETY 139, 141 (Jan. 1986).

15 Henry C. Wallich, Member, Bd. of Governors of the Fed. Rsrv. Sys., Financial Deregulation in the United States & in Developing Countries, Paper presented to Int'l Conf. on Fin. Dev. of Latin America & Carribbean, Caracas, Venezuela (Feb. 29, 1985).

16 *See generally* Cornett et al., *supra* note 12 at 91.

17 *See id.* at fn.7.

investors through access to material information."[18] When armed with the right amounts and kinds of information, investors "are well-positioned to evaluate their investment opportunities and to allocate their capital as they see fit."[19]

While regulation has often been blamed for increased economic costs, addressing likely economic impacts has become a staple of the SEC's enactment process for market regulations over the past decade.[20] For example, the current offering exemption framework contains differing levels, designed to allow issuers the flexibility to choose their economically optimal balance of regulatory burden and available capital.[21]

Alternatively, deregulation is a far less precise method of governing markets that is typically employed to combat market downturns. Often thought of as addition by subtraction, deregulation occurs when regulators take a *laissez faire* approach in order to allow market forces to further the regulator's objectives organically.[22]

Allowing organic market forces to further objectives is a key point in discussing the theoretical economic concept of deregulation. It makes little sense to deregulate for nothing more than the sake of the political brownie points of deregulating, just as the case would be for imposing regulations. Whether it be simplifying the rulebook or adding to it, changes should be done for a strategic and logical purpose. When organic market forces could accomplish regulatory objectives more efficiently, or when the objectives themselves have changed, deregulation is a logical means to a rational end.

There are two basic elements of effective financial deregulation: (1) a regulation that currently creates economic cost beyond its economic benefit (2) that, when relaxed, repealed, or amended, would lead market

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[18] Letter from Stacey Cunningham, President, NYSE Group, to Vanessa Countryman commenting on SEC Release 34-84842, https://www.sec.gov/comments/s7-26-18/s72618-5165052-183443.pdf.

[19] Commissioner Troy A. Paredes, Remarks at the SEC Speaks in 2013 (Feb. 22, 2013) (transcript available at https://www.sec.gov/news/speech/2013-spch022213taphtm); *see also* Chair Mary Jo White, The SEC after the Financial Crisis: Protecting Investors, Preserving Markets (Jan. 17, 2017) (transcript available at https://www.sec.gov/news/speech/the-sec-after-the-financial-crisis.html) ("Investors expect, and rely on, full and accurate disclosure to make investment decisions and take risks; the Commission, in turn, is charged to act sharply to stop fraud and prevent unfair and dishonest practices, including misleading disclosures").

[20] *See Implementation of the Current Guidance on Economic Analysis in SEC Rulemakings*, Rep. 516*,* U.S. SEC. & EXCH. COMM'N (June 6, 2013), https://www.sec.gov/files/516.pdf.

[21] *See* Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COLUM. BUS. L. REV. 1, 5 (1999).

[22] *See id.*; *see also* Elias Semaan & Pamela P. Drake, *Deregulation & Risk*, 40 FIN. MGMT. 295, 295 (Summer 2011).

participants to make more economically efficient decisions.[23] As applied, removing or amending rules and regulations that affect economic decisions made by firms[24] and that no longer further regulators' goals, deregulation can produce positive economic results.[25] Typically, market deregulation is designed to open an industry to competition, which should stimulate innovation and the development of products that benefit consumers.[26] However, deregulated competition can also affect profitability, as deregulation decreases compliance costs but also lowers barriers to entry.[27] Deregulation also risks losing the qualitative benefits of the original regulation. All things included, one must remember that deregulation's historical rarity and varied effects have shown only that it is an inexact science—positive outcomes are not guaranteed.[28]

PART 2: TODAY'S TRIO OF DEREGULATORY PROPOSALS[29]

"*Technology and innovation are constantly disrupting—in mostly positive ways—the manner in which markets work and investors transact. The SEC must recognize this and strive to ensure that our rules and operations reflect the realities of our capital markets."*[30]

While regulators have implemented deregulatory changes in the past, the regulatory renovation efforts in capital markets in recent years have been borderline revolutionary by comparison. Since Donald Trump's inauguration, market regulators have embarked on a widespread regulatory reformation focused on thinning the rulebook.[31] Over the final two years of the Trump administration, market regulators proposed three particularly significant deregulatory efforts to: (1) scale down the quarterly reporting requirements for public companies; (2) simplify the exemption

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23 *See* Wallich, *supra* note 15, at 115.
24 *Id*.
25 *See* Horwitz, *supra* note 14.
26 Elias Semaan & Pamela P. Drake, *Deregulation & Risk*, 40 FIN. MGMT. 295, 295 (2011).
27 *See id.*
28 *See* Lawrence G. Goldberg & Lawrence J. White, THE DEREGULATION OF THE BANKING & SECURITIES INDUSTRIES 115 (Lexington Books 1979).
29 Author's Note: This comment was originally submitted for publication in February 2020 and as such does not contain a full discussion of the various SEC proposing and adopting releases; however, citations to such releases are provided for reference where applicable.
30 Jay Clayton, Chairman, Sec. & Exch. Comm'n, Remarks on the Economic Club of New York (July 12, 2017), https://www.sec.gov/news/speech/remarks-economic-club-new-york.
31 *See* Exec. Order No. 13771, 82 Fed. Reg. 22 (Feb. 3, 2017).

framework for securities offerings; and (3) slash the traditional prerequisites for investing in private markets.

Contextually, the prosperity of US capital markets, from 2018 until the onslaught of the COVID-19 pandemic in March 2020, provides a highly relevant backdrop to consider when analyzing these proposals. Affluence in public markets during this period is evidenced by the S&P 500's five record highs and second-largest yearly gain in two decades in 2019.[32] Meanwhile, private hedge fund managers came into 2018 with more money than ever before: an estimated $3.2 trillion in assets under management—an increase of approximately 128% since 2009.[33] This departure from the traditional rationale of utilizing deregulatory measures during economic downturns, or "bear" markets, makes the fact that these proposals were made within a time period of market affluence very significant.

2.1 – Relaxation of Quarterly Reporting

Copious factors in recent years have contributed to a market ecosystem that values a short-term alignment at the expense of long-term growth focus. As then-SEC Chairman Clayton noted, "An undue focus on short-term results among companies may lead to inefficient allocation of capital, reduce long-term returns for Main Street investors, and encumber economic growth." The Nasdaq staff similarly expressed in their comment letter, "the trend away from long-termism not only impacts companies but also harms the vast majority of investors."[34] According to the results of one Nasdaq survey, 74% of listed company respondents believed that over 40% of their influential investors value short-term returns over long-term returns—a chilling trend.[35] Furthermore, nearly half of all reporting company respondents reported feeling business constraints about engaging in long-term investments.[36]

Starting in 2017, regulators and politicians began to murmur about reductions to the reporting frequency and content requirements of public company filings. In August 2018, then-President Trump formally directed the SEC to begin exploring the possibility of eliminating the quarterly

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32 *See S&P 500 Index - 90 Year Historical Chart*, MACROTRENDS, https://www.macrotrends.net/2324/sp-500-historical-chart-data.

33 *HFR Global Hedge Fund Industry Report- Year End 2017 published*, HEDGE FUND RESEARCH 1, 1 (Jan 19, 2018).

34 Sec'y of Sec. and Exch. Comm'n of the U.S., Comment Letter on the Short-Term/Long-Term Management of Public Companies, Our Periodic System and Regulatory Requirements (July 18, 2019), https://www.sec.gov/comments/s7-26-18/s72618-5825362-187511.pdf.

35 *Id.*

36 *Id.*

reporting requirements for public companies all together,[37] later claiming via Twitter that the idea had been posed to him by an unnamed business leader who allegedly said such a change would "allow greater flexibility and save money."[38]

The Executive Branch was not alone though, as both chambers of Congress approved a provision on "modernizing disclosure for investors."[39] Congress's request, however, was much milder and well-thought out than the 140 characters emanating from the White House. In particular, Congress only requested that the SEC provide a cost-benefit analysis on scaled disclosure and the use of Form 10-Q[40] for quarterly reporting with a focus towards smaller, emerging growth companies.[41]

Decreasing the quarterly disclosure burden had also been on the mind of Jay Clayton ever since his first public comments as SEC Chairman. In that 2017 speech, Chairman Clayton expressed that the results of increased disclosure requirements and other reporting burdens on public companies would be, "in two words, 'not good.'"[42] Eventually, the Commission followed suit and issued a formal release requesting public comments on the potential implications of a reduction to quarterly reporting.[43] Through a rather broad prompt, the SEC sought industry input on cutdowns to quarterly disclosure obligations as well as the growing trend toward short-term outlooks by both investors and management teams. Amongst the

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37 Michael Posner, *Why Quarterly Reporting From Business Makes Sense*, FORBES (Aug. 17, 2018, 1:46 PM), https://www.forbes.com/sites/michaelposner/2018/08/17/why-quarterly-reporting-from-business-makes-sense/?sh=4a9630627ed8.

38 *See Should Companies Abandon Quarterly Earnings Reports?*, WHARTON SCH. OF THE UNIV. OF PA. (Aug. 27, 2018), https://knowledge.wharton.upenn.edu/article/ending-quarterly-reporting/ (identifying the commenter as former Pepsi CEO Indra Nooyi who later explained that her comment was taken out of context by Trump).

39 S. 488, 115th Cong. § 2201 (2018). Note: provision contained within the JOBS & Investor Confidence Act of 2018 bill that passed in both houses but died at the end of the 115th Congress due to different versions of other, unrelated provisions.

40 *See* SEC, Form 10-Q General Instructions, https://www.sec.gov/about/forms/form10-q.pdf (10-Q filings are the quarterly reports that public companies file with the SEC to provide regulators and investors alike with financial statements, general risk information pertinent to the business, and other miscellaneous disclosures).

41 *See* EVA SU & GARY SHORTER, CONG. RSCH. SERV., R45308, JOBS AND INVESTOR CONFIDENCE ACT: CAPITAL MARKETS PROVISIONS 7 (2018).

42 *See* Clayton, *supra* note 30; *see also* Mark Lebovitch & Jacob Spaid, *In Corporations We Trust: Ongoing Deregulation & Government Protections*, HARVARD LAW SCH. F. ON CORP. GOVERNANCE (Feb. 6, 2019), https://corpgov.law.harvard.edu/2019/02/06/in-corporations-we-trust-ongoing-deregulation-and-government-protections/.

43 *See* Request for Comment on Earnings Releases and Quarterly Reports, U.S. SEC. & EXCH. COMM'N, Rel. Nos. 33-10588, 34-84842 (Dec. 18, 2018).

nearly 100 responses were comment letters from the NYSE, Nasdaq, and each of the four major accounting firms.[44]

There is a multitude of options when it comes to regulating the flow of public company information; however, an approach based upon mandatory disclosure has been overwhelmingly favored since the initial federal securities laws from the New Deal era.[45] It is no secret that companies spend into the millions on reporting costs and are not always eager to expound on poor short-term results or reveal new material risks facing the business; yet, pursuant to federal securities regulations such revelations must be publicly made every three months.[46] Thus, the proposal to reduce a major aspect of the reporting regime was a noteworthy topic for issuers and investors.

Separately, Chairman Clayton set out to cut back on the plethora of legalese that he claimed hinders Main Street investors understanding of company reports. He noted the current trend where "the median word-count for SEC filings has more than doubled, yet readability of those documents is at an all-time low," expressing his desire to buck the trend by providing more basic press-release styled information.[47] The then-Chairman conveniently failed to mention that it was already commonplace on the market for registrants to report quarterly earnings results in a press release furnished in a current report on Form 8-K. Improving the readability of public disclosures and counteracting the short-term mentality of both Wall Street and reporting companies themselves were also regularly cited as justifications.[48] And by proposing an end to certain quarterly reporting requirements, regulators strove to move investment markets away from the "unhealthy focus on short-term

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[44] Stacey Cunningham, Comment Letter on Earnings Releases and Quarterly Reports (March 21, 2019), https://www.sec.gov/comments/s7-26-18/s72618-5165052-183443.pdf; John A. Zecca, Comment Letter on Earnings Releases and Quarterly Reports (March 21, 2019), https://www.sec.gov/comments/s7-26-18/s72618-5165052-183443.pdf; KPMG LLP, Comment Letter on Earnings Releases and Quarterly Reports (March 21, 2019), https://www.sec.gov/comments/s7-26-18/s72618-5165052-183443.pdf; Deloitte & Touche LLP, Comment Letter on Earnings Releases and Quarterly Reports (March 21, 2019), https://www.sec.gov/comments/s7-26-18/s72618-5165052-183443.pdf; Ernest & Young LLP, Comment Letter on Earnings Releases and Quarterly Reports (March 21, 2019), https://www.sec.gov/comments/s7-26-18/s72618-5165052-183443.pdf; PWC LLP, Comment Letter on Earnings Releases and Quarterly Reports (March 21, 2019), https://www.sec.gov/comments/s7-26-18/s72618-5165052-183443.pdf.

[45] Elisabeth de Fontenay, *The Deregulation of Private Capital & the Decline of the Public Company*, 68 HASTINGS L. J. 445, 474 (2017).

[46] *See generally* Posner, *supra* note 37.

[47] Clayton, *supra* note 30.

[48] *See* Posner, *supra* note 37.

profits at the expense of long-term strategy, growth, and sustainability."[49] Combating the apparent short-term mentality on Wall Street is one objective also supported by several prominent investors. In fact, certain sophisticated investors and corporate executives have explained that, "in both national policy and business, effective long-term strategy drives economic growth and job creation."[50]

2.2 – Harmonization of Offering Exemptions

For private market issuers, the most significant deregulatory move proposed in a 2019 SEC concept release was the simplification of the framework for private securities offering exemptions.[51] The Concept Release on Harmonization of Securities Offering Exemptions[52] ("***Harmonization Initiative***" or "***Harmonization***") exemplified the tremendous breadth of the deregulatory changes being considered by the Commission during that time.[53]

In the bigger picture though, the reformation is to restructure the exempt offering framework to ensure that the system—as a whole—is rational, accessible, and effective.[54] The release suggests that the current regulatory framework governing offerings exempt from registration may be overly complex, duplicative, and inefficient.[55] The Commission also repeatedly invokes an incentive to assist smaller companies which "may find it difficult to manage this complexity";[56] however, several of the exemption requirements that would be relaxed would affect larger issuers as well. Although the SEC addresses the issue of complexity throughout the entire exemption framework, a major focus is the simplification of the regulatory exemption under Rule 506(b) of Regulation D. This is noteworthy for the fact that the Rule 506(b) exemption has accounted for

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49 Jamie Dimon & Warren E. Buffet, *Short-Termism Is Harming the Economy*, WALL STREET JOURNAL (June 6, 2018, 10:00 PM), https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801.

50 *Id.*

51 A concept release is to solicit the public's views on securities issues in order to evaluate the need for future rulemaking.

52 *See* Concept Release on Harmonization of Securities Offering Exemptions, U.S. SEC. & EXCH. COMM'N, Rel. Nos. 33-10649; 34-86129; IA-5256 (June 18, 2019).

53 *See* Era Anagnosti & Colin J. Diamond & David Johansen & John Vetterli, *SEC: Time to revamp securities offering exemptions*, WHITE & CASE LLP (July 23, 2019), https://www.lexology.com/library/detail.aspx?g=5945214c-f980-4f26-a3ba-fdce62e42ae0.

54 Jay Clayton, Chairman, Sec. & Exch. Comm'n, Remarks on Capital Formation at the Nashville (August 29, 2018).

55 *See id.*

56 Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 52, at 6.

more than half of all private capital raised in recent years.[57] The proposed changes to the 506(b) exemption alone would make the Harmonization a mammoth of a deregulatory move.

Furthermore, the Harmonization Initiative was designed to improve the liquidity of securities issued pursuant to an exemption to the registration requirements by reducing holding periods and resale restrictions.[58] The proposal acknowledges how limited secondary market liquidity (a) impacts issuers' ability to attract investors, and (b) impairs "investors' ability to diversify their portfolios over time."[59] However, any drastic change would have potentially wide-ranging impacts on public market volatility. In response, the Harmonization Initiative strives to alleviate that problem through the seeming compromise of additional resale transaction exemptions.

2.3 – Widening "Accredited Investor" Qualifications

Tucked in the back half of the same June 2019 concept release was an independently significant proposal to reduce the restrictions on who can invest in non-public offerings. Specifically, it proposed expansion of the "accredited investor" definition's longstanding quantitative thresholds by way of new sophistication criteria to meet such revised accreditation threshold. This widening of qualifications was noteworthy because the accredited investor definition is "a central component of several exemptions."[60] Traditionally, an "accredited investor" has been defined as a person who met any of the eight monetary-based standards enumerated in Rule 501(a) of Regulation D.[61] Those wealth and income standards reflect the SEC's original 1982 determination "that those individual investors best able to protect themselves from securities fraud were those able to withstand being fleeced, i.e., the wealthy."[62]

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57 *Id.* at 19 (table 2).

58 *See* Anagnosti et al., *supra* note 53; *see generally* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 52, at 193-210.

59 Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 52, at 193-94.

60 *Id.* at 32.

61 *See* 17 C.F.R. § 230.501(a) (specifically, the individual investors must have either an annual income of $200,000 individually (or $300,000 with spouse)), or a $1 million net worth (excluding the value of personal residence) in order to currently qualify as an accredited investor).

62 David Stockton, *How The SEC Could Expand Access To Private Offerings*, KILPATRICK TOWNSEND (July 16, 2019), https://www.kilpatricktownsend.com/en/Blog/securities/2019/7/How-The-SEC-Could-Expand-Access-To-Private-Offerings (mentioning also that the definition enacted in 1982 has only been significantly amended once in 2010 to remove the value of an investor's personal residence from the individual wealth calculation).

Specifically, the SEC proposed two categories of changes to the accreditation definition: (1) amending the current monetary standards, and (2) adding new sophistication criteria.[63] First, the Commission's proposal (based largely on SEC staff recommendations) suggested that the longstanding income and net worth requirements remain as is, but be adjusted for inflation going forward.[64] The recommended alternative to that approach would be to limit a single investment at 10% of the investors annual income.[65] Second, the proposed addition of sophistication thresholds involved a bevy of potential criteria for becoming an accredited investor.[66] Such suggested criteria included items such as level of investment experience, industry-based examinations, or even simple opt-in clauses after risk disclosures.[67]

The two primary reasons behind the proposed changes to the accredited investor definition were: (1) public vs. private market opportunity imbalances, and (2) several years of unheeded staff recommendations that had been supported by the industry. The imbalance of public versus private market opportunities stems from the declining growth of public market investment opportunities in contrast with booms in private market investment offerings.[68] The intent to expand investor access stems from the astronomical returns to private equity and venture capital investors from several now-public tech unicorns[69] that were criticized as overvalued when sold to the public.[70] "As a result, the call has become louder and more frequent that the middle-class investor is being unfairly discriminated against by being shut out from participating in these higher return offerings."[71] Essentially, it became clear that those allowed in as early-stage private investors made off with exorbitant returns as public investors were left holding the bag when large valuations fell apart

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63 *See* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 52, at 54-60.

64 *Id.*

65 *See id.* at 39, 52-55.

66 *See id.*

67 *See id.* at 50-56.

68 *See* Michael Ewens and Joan Farre-Mensa, *The Deregulation of the Private Equity Markets & the Decline in IPOs*, 33 REV. OF FINANCIAL STUDIES 5463 (2020).

69 The term "unicorn" is used to refer to startup companies reached $1+ billion valuations with only private investment. *See* Aileen Lee, *Welcome to the Unicorn Club: Learning from Billion-Dollar Startups*, TECHCRUNCH (Nov. 2, 2013), http://techcrunch.com/2013/11/02/welcome-to-the- unicorn-club.

70 *See generally* David Trainer, *The Unicorn Bubble is Bursting*, FORBES (Oct. 7, 2019), https://www.forbes.com/sites/greatspeculations/2019/10/07/the-unicorn-bubble-is-bursting/#1da928a88198

71 Stockton, *supra* note 62, at 2.

over time through more disclosure and greater price discovery in the public markets.

The proposed expansion of accreditation restrictions had two conceptually ambitious goals in addressing those imbalances. First, to expand access by increasing the number of investors eligible to participate in private markets. Second, to increase the amount of capital that is available to businesses through exempt private offerings. In simple terms, the proposed alterations to the accredited investor qualifications were designed to increase both supply and demand of private capital without harming the "private offering ecosystem."[72]

In addition to the influence of unbalanced market opportunities, calls for revisions to the accredited investor definition had been coming from within the regulatory agencies since as early as 2015, when the Commission released a staff report which recommended alternative approaches to the definition.[73] However, no changes were made to the applicable regulation. In every year since then, internal departments of both the SEC and Treasury have formally recommended cutting the requirements for accreditation.[74] Finally, in response, the Commission's 2019 concept release factors in the overwhelming amount of industry support received over the years in response to SEC staff's recommended changes to the accredited investor definition.[75] In fact, one of the most strongly supported ideas had been the "creation of additional methods of accreditation other than financial criteria," which is now a centerpiece of this proposal.[76]

PART 3: HISTORICAL LESSONS IN DEREGULATION

"There is no better teacher than history in determining the future. There are answers worth billions of dollars in a $30 history book."[77]

History is meant to be learned from, so as to prevent the repetition of man's mistakes. In order to do so, the reasons for past successes and failures must first be understood themselves. This ideal is as true for

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72 *See* Comment from Advisory Committee on Small & Emerging Companies, *Recommendations Regarding the Accredited Investor Definition* (July 20, 2016).

73 *See generally* Concept Release on Harmonization of Securities Offering Exemptions, *supra* note 52, at 41-44.

74 *See id.* at 44-45.

75 *Id.*

76 *Id.*

77 Charlie Munger, *Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger* (2005) (Mr. Munger is widely regarded as one of the most successful investment minds of the 21st century, Munger has been the Vice Chairman of Berkshire Hathaway since 1978).

market regulation as it is in all aspects of human society. This portion of the comment lays out deregulatory changes of past eras in detail to provide how to evaluate the efficacy of today's proposals.

For context, the change in theoretical economic understanding of regulation in the 1960s and 1970s provided a catalyst for a new era of deregulating financial markets.[78] Traces of the 1970's newfound economic theory, where regulations raise prices and reduce competition, can be seen differently in the deregulatory changes of that era. One example shows how reduced regulation can stimulate market competition and innovation. While the other demonstrates how deregulation can achieve its desired direct results but indirectly reduce competition. In more recent history, the late 1990s to early 2000s was arguably the most pronounced deregulatory era in US capital markets that the nation has ever seen. Four different deregulatory moves that occurred in that time period, and their eventual effects, are explained and analyzed with the context of that time period's market conditions in mind.

3.1 – "Mayday" (1975)

At the time, May 1, 1975 was considered by some to be the most momentous day on Wall Street since the forming of the original stock exchange in 1792.[79] On what is now commonly referred to as "Mayday," regulators abolished the fixed-rate commissions floor for securities brokers.[80] For 183 years, the cost per share for investors to make a trade had remained nearly the exact same. Whether it was 100 shares of Proctor & Gamble in 1891 or 100,000 shares of Coca-Cola in 1974, the broker charged the investor at least 2% for the trade.[81]

Amid mounting political and judicial anti-trust concerns, SEC Rule 19b-3 deregulated commission rates with the goal of inducing a level of free-market pricing competition that the financial services industry had never seen before.[82] Initially, well-established brokerage houses vehemently opposed the deregulation due to the profit losses that competition would cause. However, those Wall Street bankers eventually

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78 *But see* Edward J. Balleisen, Fraud: An American History from Barnum to Madoff, 368, PRINCETON U. PRESS (2017) (discussing the intermittent spots of regulatory action that occurred during the mid-1970's when deregulatory freedom offered to businesses and market actors was occasionally interrupted by stricter enforcement stances, the majority of which were in response to widely-reported fraud scandals that caught the eyes of firms and investors alike).

79 Jason Zweig, *Lessons of May Day 1975 Ring True Today*, WALL ST. J. (Apr. 30, 2015).

80 *Id.*

81 *Id.*

82 *See id.*

basked in the newfound industry prosperity that Mayday had ignited. In fact, Mayday sparked a whole new era of innovation for the financial services industry and provided quantitative benefits to markets in general. Mayday's deregulation created a necessity to innovate and evolve.[83] Although Mayday did temporarily damage bottom lines in 1975, it also produced a need to create new revenue streams at brokerage houses. That need led to the creation of new investment products, many of which are still widely used today.[84] In addition, equity markets also reaped indirect benefits of greater liquidity that resulted from the rise in trading volumes on the NYSE,[85] where trading in 1976 had increased 52.36% from just two years prior.[86]

Similarly, Mayday didn't lead to immediate benefits for smaller individual investors, often referred to as "retail" or "main street" investors.[87] Deregulation had led to a decline in average trading commissions through competition for the biggest clients; however, retail investors actually faced an increase in average rates from the pre-Mayday average of $0.30/share to around $0.41/share afterwards.[88] Though, a few years later, growth in competition for business and entry of new discount brokerages eventually resulted in lower prices for retail investors.[89] Additionally, the industry's newfound marketing focus and the plethora of new financial products and services offered to retail clients meant more options and opportunities for those main street investors who had limited choices on where to put their money pre-Mayday.[90]

3.2 – Shelf Registration & Rule 415 (1982)

Adopted in 1982, Rule 415 of the Securities Act[91] deregulated offering restrictions by allowing for "shelf registration"; which permitted large issuer corporations to file a registration statement and subsequently issue securities anytime during a period of up to two years.[92] The basic premise behind the adoption of Rule 415 was the ability to streamline the process

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83 *See id.*

84 *See* Zweig, *supra* note 79 (explaining the invention of zero coupon bonds and money-market accounts, among others).

85 *See id.*

86 New York Stock Exchange, Inc., New York, N.Y., "Facts & Figures", available at http://www2.census.gov/library/publications/2011/compendia/statab/131ed/tables/12s1210.xls.

87 Zweig, *supra* note 79.

88 See *id.*

89 *See id.*

90 *See id.*

91 17 C.F.R. § 230.415 (2020).

92 Cornett et al., *supra* note 12, at 86.

of certain issuers bringing their securities into public markets by reducing complex red tape and the costs associated with it.[93]

The desire to alter what was an inflexible system of offering securities, in terms of timing and offering design, was a central goal for Rule 415.[94] The intention was to eliminate obvious redundancies through an integrated system of securities registration that would streamline the disclosure system.[95] "The new system was designed to reduce compliance costs by eliminating duplicative disclosure, while providing investors with all necessary information in a timely manner."[96] A key component was revising what was considered "timely information" in order to reduce the costs associated with repetitive disclosure.[97] That revision essentially permitted issuers and underwriters to make the necessary disclosures once, at the beginning of the shelf period, and then conduct offerings continuously over the next two years.

The root causes that led to Rule 415 came from a mixed bag of market trends toward such behaviors and regulator fear of losing out to international competition. The trend toward Rule 415 stemmed from the need created by Mayday for additional revenue streams at financial institutions. That need led to an increase in "bought deals," where underwriters would purchase the majority of an issue of registered securities and then eventually distribute them publicly.[98] In addition, regulators were motivated to loosen up the offering restrictions due to the pressure of keeping US issuers from migrating to other international markets.[99]

The results of Rule 415 were both positive and negative. On the positive side, compliance and disclosure costs incurred by issuers declined.[100] Over the handful of years leading up to, and following the SEC's passage of Rule 415, there was a significant concentration of the investment banking industry.[101] That trend intensified as both shelf and non-shelf issuers turned to a smaller circle of the most prominent

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93 *See id.*

94 *See* David S. Allen, Robert E. Lamy, & G. Rodney Thompson, *The Shelf Registration of Debt & Self Selection Bias*, 45 J. OF FINANCE 275, 277 (1990).

95 *Id.* at 276.

96 *Id.*

97 *Id.*

98 *See* Arthur E. Wilmarth Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, & Increased Risks*, 2002 U. ILL. L. REV. 215, 327 (2002).

99 Palmiter, *supra* note 21, at 40-41.

100 *See* Mary C. Neary, *SEC Rule 415: Resolving the Dilemma*, 3 PACE L. R. 275, 282 (Jan. 1983).

101 Cornett et al., *supra* note 12, at 87.

underwriters in the business[102] suggesting that other factors contributed to the sector's contraction as well. For shelf issuers specifically, those trends can be attributed to the fact that the most well-funded investment banks were able to purchase and hold the issuer's securities during the shelf period, unlike less well-capitalized firms.[103]

While the shelf-registration trend certainly allowed greater freedom to issuers, it also created risk of isolated incidents of large-scale losses at investment banks. For example, British Petroleum's 1987 shelf offering cost four US securities firms more than $300 million in just a few days when the stock market crash dropped share prices and the lack of liquidity left the banks holding the bag.[104] During that same crash, securities firm County NatWest "suffered a similar loss as lead underwriter for a public offering of Blue Arrow stock" when lack of investor demand led to a 50% decline in Blue Arrow share price.[105]

3.3 — National Securities Market Improvement Act (1996)

In 1996, the National Securities Market Improvement Act ("***NSMIA***") overhauled the way securities markets were overseen by removing state regulators from the picture while also flooding private markets with a wave of new capital. In particular, NSMIA allowed federal securities law to preempt states' registration and qualification requirements for "covered securities."[106] While covered securities included those that were publicly listed and sold to large institutional investors, they also included securities that were offered in private markets under certain federal exemptions to the Securities Act.[107] Prior to the NSMIA, more than 75% of states required some form of merit-based review of securities before they could be approved for an offering.[108] Both the issuing company and the investment securities themselves were measured against substantive state standards. However, NSMIA "largely eliminated what substantive review had remained for private offerings."[109]

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102 *Id.*
103 *See id.*
104 Wilmarth, *supra* note 98, at 411.
105 *Id.*
106 Justin Blount & Drew Thornley, *Federal Preemption in Securities Laws, the Investment Contract, and Macroprudential Financial Regulation*, 14 DEPAUL BUS. & COMM. L.J. 273, 281 (2016).
107 *Id.*
108 *Id.*
109 Robert B. Robbins and Ella M. Lvov, *The Rise of Unicorns and the Decline of Public Markets*, 33 INSIGHTS 1, 7 (Apr. 2019), https://www.pillsburylaw.com/images/content/1/2/v2/124396/INSIGHTS-2019-04-30.pdf.

Separately, § 209 of NSMIA lifted the cap on the number of clients that hedge funds could bring in so long as they met certain sophistication and asset requirements.[110] Capital rushed into funds so fast that by 2003 hedge fund assets had grown to ten times their pre-NSMIA value. The legislative rationale for NSMIA was based around the idea that less burdensome regulation would promote efficiency and capital formation without giving up investor protections.[111] In the marketplace however, large institutional investors and hedge funds supported NSMIA as a way to get into private market opportunities offering alpha earning capabilities. The longer-term effect of NSMIA was the drastic decline in public offerings after 1996. NSMIA did in fact increase the supply of capital to private companies. But it was almost entirely to late-stage, larger companies;[112] it changed next to nothing for smaller issuers.[113]

3.4 – Gramm-Leach-Bliley Act (1999)

One of the most well-known deregulatory actions in financial markets over the past century was the gradual repeal of the Glass-Steagall Act that was capped off in 1999 with the Gramm-Leach-Bliley Act ("***GLB***").[114] Also known as the Financial Modernization Act,[115] GLB was the legislative capstone to over a decade of deregulating investment banking.[116] The act itself formally repealed all restrictions against financial institutions combining banking, securities, and insurance businesses.[117]

Enacted in the same year of twenty-four record-setting closes for the Nasdaq,[118] GLB was spurred on by the technological advances around the turn of the millennium. At the time, rapid innovation in the financial services industry led to new products, new services, and new providers available to investors.[119] With newer, more lucrative options available for

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110 *See* David Dayen, *What Good Are Hedge Funds?*, THE AMERICAN PROSPECT (Spring 2016), https://prospect.org/power/good-hedge-funds/.
111 *See* Rutheford B. Campbell Jr., *The Impact of NSMIA on Small Issuers*, 53 BUS. LAWYER 2, 575, 579-80 (1998).
112 *See* Ewens, *supra* note 68, at 5487-88.
113 Campbell, *supra* note 111, at 583.
114 *See* Matthew Sherman, A SHORT HISTORY OF FINANCIAL DEREGULATION IN THE UNITED STATES 2 (2009), https://www.cepr.net/documents/publications/dereg-timeline-2009-07.pdf.
115 12 U.S.C. § 1843 (2018).
116 Sherman, *supra* note 114, at 10.
117 *Id.*
118 *See Nasdaq Official Closing Price Historical Data*, Nasdaq.com, https://old.nasdaq.com/aspx/historical_nocp.aspx?symbol=NASDAQ&selected=NASDAQ (last visited Apr. 11, 2021) (referencing the Nasdaq Composite Index, known as a benchmark index for tech investments).
119 Wilmarth, *supra* note 98, at 435.

savings, investor demand shifted from old-school bank deposits to new-age products such as mutual funds and variable annuities.[120] As competition increased, banks needed to expand into these new markets for survival but were barred from doing so by Glass-Steagall.[121]

In 1986 the Federal Reserve began to carve away at Glass-Steagall by reinterpreting the act's restrictions and allowing consumer banks to derive up to five percent of their gross revenue via investment banking.[122] Chairman of the Federal Reserve at the time, Alan Greenspan's stance on the role of government regulation was clear: "[I]f private market regulation is effective, then government regulation is at best unnecessary. At worst, the introduction of government regulations unavoidably involves some element of moral hazard."[123] Still prior to the passage of GLB, "the legal barriers to financial consolidation were 'all but rendered . . . moot' by the 1998 decision of the Federal Reserve Board's approving a merger between Citicorp and Travelers."[124] The merger created the largest financial institution in the world at the time.[125]

In November 1999, the enactment of the GLB Act provided the final nail in Glass-Steagall's proverbial coffin. "The act recognized the market reality that it was becoming increasingly difficult to maintain traditional distinctions between many of the activities of commercial banks, investment banks, and insurance companies."[126] The primary goal of GLB can be thought of simply as codified acquiescence toward the administrative decisions already handed down by the Fed. Nonetheless, Congress did have its own stated goals for the repeal. Primarily, listed atop the enacted bill was Congress's main objective: "To enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers . . . ."[127]

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[120] *See id.*

[121] *See* Balleisen, *supra* note 78, at 358 (explaining that the Glass-Steagall Act was the partition which kept the largest banks from entering into the securities or insurance territories of financial markets).

[122] Sherman, *supra* note 114.

[123] Alan Greenspan, Chairman, The Fed. Reserve Board, "Government regulation and derivative contracts", Remarks before the Financial markets Conference of the Federal Reserve Bank of Atlanta, Coral Gables, Florida (Feb. 21, 1997).

[124] Wilmarth, *supra* note 98, at 220 (quoting Michael K. O'Neal, *Summary and Analysis of the Gramm-Leach-Bliley Act*, 28 SEC. REG. L.J. 95, 96 (2000)).

[125] *Id.*

[126] Roger W. Ferguson, Jr., Vice Chairman, The Fed. Reserve Board, Remarks at the Future of Financial Services Conference, U. of Mass, Boston (Oct. 8, 2003).

[127] Gramm-Leach-Bliley Act 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 U.S.C.A. (West 1999)).

Both the positive and negative effects of the GLB Act (and the actions which preceded it) on the financial industry cannot be overstated. On the positive side, allowing combined financial companies sparked a movement in the industry to become what become what is now the modern financial sector.[128] The GLB Act's goal of combined institutions did lead to the creation of financial services conglomerates, which made up a third of all financial holding companies.[129]

In a mix of good and bad, the immediate effects of the Financial Modernization Act allowed for increased investment and innovation by the financial industry; however, those same positive results created an evolving system filled with misunderstood risk.[130] As for the negative effects, look no further than the widespread nature of the Great Recession, where the GLB Act's hands-off approach became one of the most commonly cited culprits for the 2008 financial crisis.[131] "The very nature of many Wall Street firms changed—from relatively staid private partnerships to publicly traded corporations taking greater and more diverse kinds of risk."[132]

In practice, the Financial Modernization Act's loosening of investment banking restrictions enabled many of the nation's largest financial institutions to use their own commercial banking operations to self-fund investment activities.[133] Further, because historically separate institutions were able to legally operate under the same roof, obtaining capital to finance the work of a bank's own rapidly growing investment arm had become as simple as walking across the hall.

With more capital being more easily accessible, financial institutions began to expand their capacity to create securities themselves—most commonly asset-backed securities ("***ABS***"). In particular, these were mostly mortgage-backed securities ("***MBS***") which contained packages of mortgages bought from non-bank lenders, who utilized bank financing to issue mortgages to home buyers. Investment banks' easy access to

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128 Arthur E. Wilmarth Jr., *How Should We Respond to the Growing Risks of Financial Conglomerates, in* Financial Modernization After Gramm-Leach-Bliley (Patricia C. McCoy ed., 2002) ("Although the Citigroup merger and the GLB Act were landmark events, in a broader sense they are by products of the fundamental restructuring . . . , the dividing lines between banks, securities, firms and insurance companies began to disappear long before Congress passed the GLB Act.").

129 *See* Ferguson, *supra* note 126.

130 *See generally* Fin. Crisis Inquiry Comm'n, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL & ECONOMIC CRISIS IN THE UNITED STATES, xvii (Jan. 2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

131 *See id.*

132 *Id.*

133 *See generally* Balleisen, *supra* note 78.

financing "increased the supply of mortgage bonds and related derivatives, widening opportunities for deceptive practices in debt markets."[134]

3.5 – Commodity Futures Modernization Act (2000)

Just a year after the passage of GLB, Congress continued on its deregulatory path with the Commodity Futures Modernization Act of 2000[135] ("***CFMA***"),[136] which exempted over-the-counter ("***OTC***") derivative securities transactions between sophisticated parties from both CFTC and SEC regulation.[137] Basically, CFMA excluded certain derivatives traded in the OTC market from oversight so long as smaller retail investors were not allowed to trade.[138] The CFMA's central purpose was to allow for derivative financial contracts[139] to be legally traded in the OTC market, and therefore off the CFTC-regulated exchanges.[140] Eventually, CFMA's statutory exemption from regulation for derivatives would come to be known as the "Enron Loophole."[141]

After Mayday banks and securities firms began to create financial derivative instruments which could be traded in two ways: (1) on organized public exchanges, or (2) in OTC markets. Dominated by the largest banks, the OTC derivatives market boomed in the 1990's.[142] By the end of the year, the seven most active bank dealers in the United States held derivatives with total notional values of more than $38 trillion—seven times the value held just ten years earlier.[143]

Primarily, CFMA's hands-off approach was to make sure that regulation didn't get in the way of the dominance of US investment markets. Along with the growth and innovation came the threat of international competition in derivative markets. Both legislative and regulatory leaders began to believe that imposing regulations on the growing OTC derivatives market in the US would "discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore."[144] However, not every

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[134] *Id.*
[135] *See generally* 12 U.S.C. § 1843.
[136] *See generally* Sherman, *supra* note 114.
[137] Balleisen, *supra* note 78, at 358.
[138] MARK JICKLING, CONG. RSCH. SERV., RS22912, THE ENRON LOOPHOLE 1 (2008).
[139] *Id.* (including instruments like futures, options, or swaps, whose value is linked to the price of some underlying commodity).
[140] *Id.*
[141] *Id.*
[142] *See* Wilmarth Jr., *supra* note 98, at 333.
[143] *See* COMPTROLLER OF THE CURRENCY, OCC BANK DERIVATIVES REPORT, FOURTH QUARTER tbl.5 2000.
[144] THE PRESIDENT'S WORKING GRP. ON FIN. MKTS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT (2008).

regulator saw it that way. Chairwoman of the Commodity Futures Trading Commission ("***CFTC***") at the time, Brooksley Born, recognized dangers lurking in unregulated derivatives and spearheaded an effort to regulate them in 2000, only to be shot down by politicians.[145]

Another stated (and rather ironic) goal of CFMA's deregulation of the derivatives markets was to "reduce systemic risk."[146] In fact, the majority of Wall Street opposed the regulation of derivatives, not because of some sort of nefarious intent, but due to a sense that derivatives market was helping financial institutions manage risk better through unregulated hedging with derivatives.[147]

In the short-run, the deregulatory approach to OTC derivatives actually achieved its stated goal. US derivatives markets boomed in the years following CFMA's passage, increasing the notional value of derivatives held by US commercial banks to $182.1 trillion by the second quarter of 2008.[148] The direct contribution of the CFMA's explicit exemption of only OTC derivatives trading is exemplified by the fact that 95.5% of that value was attributable to the OTC markets.[149] With that, the growth in the OTC derivatives market also "effectively exposed all conceivable corners of the financial system to the underlying risks."[150]After the financial crisis hit in 2008, even Greenspan himself came to admit that a hands-off approach was flawed when it came to financial markets. During a congressional hearing in late 2008, he testified, "I found a flaw in the model that I perceived as the critical functioning structure that defines how the world works."[151]

As time passed, the dangerous effects of CFMA began to show through the 2001 collapse of Enron and the lack of transparency that allowed the fraud to go on as long as it did. Before the CFMA, the majority

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145 Balleisen, *supra* note 78, at 359; *see also 2000 Commodities Act Paved the Way for Problems*, NPR (Mar. 20, 2009, 4:00 PM), https://www.npr.org/templates/story/story.php?storyId=102185942 (explaining that the attempt proved to be futile when Chairwoman Born's proposal to discuss risk-protection regulation of the widely growing derivatives market was shot down by President Clinton's Working Group on Financial Markets).

146 THE PRESIDENT'S WORKING GRP. ON FIN. MKTS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT, *supra* note 144.

147 *See 2000 Commodities Act Paved the Way for Problems*, *supra* note 145.

148 *See* COMPTROLLER OF THE CURRENCY, OCC BANK DERIVATIVES REPORT SECOND QUARTER tbl.1 (2008).

149 *Id.* at tbl.3.

150 Dr. Issahaku Salifu, *The Role of Over-the-Counter (OTC) Derivatives in Global Financial Crisis and Corporate Failures in Recent Times and Its Regulatory Impacts*, 6 EUROPEAN J. ACCT., AUDITING, & FIN. RESEARCH 53, 58 (2018).

151 *The Financial Crisis and the Role of Financial Regulators*: *Hearing Before the H. Comm. on Oversight and Gov't Reform.*, 110th Cong. (2008) (statement of Alan Greenspan, former Chairman of the Fed. Reserve. Bd.).

of oil and gas derivative products were bought and held by corporations which would be afflicted by large price swings.[152] However, under the CFMA, there was no regulatory oversight of the electronic trading facilities that Enron operated on.[153] Until its 2001 collapse, Enron was hailed as an industry leader in electronic OTC market trading of energy derivatives.[154] The downfall of Enron cost nearly $70 billion in market value to thousands of investors. While Enron's downfall is largely attributed to accounting fraud and embezzlement, the lack of disclosure of the business' trading operations under CFMA allowed such deceptive practices to go undetected for nearly an entire year.[155]

3.6 – Alternative Net Capital Rule (2004)

In 2004, the SEC relaxed the "net capital rule" for the brokerage branches of the nation's wealthiest investment banks.[156] An amended Rule 15c3-1[157] essentially allowed the banks' broker-dealers[158] to use an alternative method to compute the net capital they were required to keep as emergency reserves.[159] One intriguing aspect of the amendment was the SEC's firm stance that the amendment wasn't deregulatory at all, but rather an increase in regulatory supervision.[160] Although the alternative net capital rule did include financial reporting requirements, it also cut the reserves those large Wall Street firms were required to hold by as much as 80%.[161] Essentially, it allowed abundantly more risk to be taken so long as it was disclosed. While hindsight is 20/20, it is worth noting that the SEC's head of market regulation in 2004 reassured the voting commissioners that

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152 *See generally* Kenneth B. Medlock III & Amy Myers Jaffe, *Who is in the Oil Futures Market and How Has It Changed?*, BAKER INST. (Aug. 26, 2009), https://www.bakerinstitute.org/media/files/Research/ef37edfc/EF-pub-MedlockJaffeOilFuturesMarket-082609.pdf.

153 *See id.*

154 *See* JICKLING, *supra* note 138, at 2 n.2.

155 *See To Consider the Reauthorization of the Commodity Futures Trading Commission: Hearing Before the Comm. on Agric., Nutrition, and Forestry U.S. Senate*, 109th Cong. 208-10 (2005).

156 *See* Sherman, *supra* note 114, at 11.

157 This is commonly referred to as the "net capital rule."

158 *See* 17 C.F.R. § 240.15c3-1 (2004); *see also* U.S. GOV'T ACCOUNTABILITY OFF., GAO-04-896R, SECURITIES AND EXCHANGE COMMISSION: ALTERNATIVE NET CAPITAL REQUIREMENTS FOR BROKER-DEALERS THAT ARE PART OF CONSOLIDATED SUPERVISED ENTITIES (2004) (explaining that the eleven largest broker-dealers at the time would utilize the rule change).

159 *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 158.

160 *See* Erik R. Sirri, Director, SEC, Remarks at the National Economists Club: Securities Markets and Regulatory Reform (Apr. 9, 2009).

161 *See* John Carney, *The SEC Rule That Broke Wall Street,* CNBC (Mar. 21, 2012, 1:42 PM), https://www.cnbc.com/2012/03/21/the-sec-rule-that-broke-wall-street.html.

the new rule would allow the SEC to restrict the firms from excessively risky activity.[162]

Similar to most deregulatory moves of its time, the alternative net capital rule was "motivated by industry complaints of excessive regulation at a time of growing competition from overseas."[163] Specifically, the European Union was on the verge of imposing regulatory burdens on the foreign operations of US investment banks.[164] However, the most influential catalyst for the amendment came from the investment banks themselves. Goldman Sachs CEO, Henry Paulson Jr., led the group of five investment banks in a lobbying effort to rid themselves of what they believed were outdated regulatory burdens.[165] In a show of support and confidence in the investment banks just prior to the 2008 financial crisis, then SEC Chairman, Christopher Cox, reassured investors by stating on the record, "We have a good deal of comfort about the capital cushions of the these firms at the moment."[166] Another basis for amending the net capital rule was one of boosting supply-side capital. By allowing the new method of computation, firms could redeploy massive sums of excess net capital into markets.[167] Billions of dollars that the banks' brokerage arms had been keeping as reserves against investment losses were freed up.[168] Then, the newly freed-up funds flowed up to the parent company, where it would be invested in "the fast-growing but opaque world of mortgage-backed securities; credit derivatives . . . ; and other exotic instruments."[169]

The immediate effect of the amendment to the net capital rule was an increase in the leverage ratio of the largest firms.[170] One of the most extreme examples, in the months following the deregulatory move Bear Stearns would increase its leverage to the point where it had $33 in debt for each dollar in equity.[171] Industry debates continue as to the weight in which the 2004 amendments to the net capital rule caused the financial crisis. However, there is general agreement that the change was a primary factor in how widespread the crisis became.[172] Economists note the fact that the "change in capital requirements led to an explosion of issuance of

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162 Stephen Labaton, *The SEC Rule that Let Banks Pile on Debt*, N.Y. TIMES (Oct. 3, 2008, 6:18 AM), https://www.cnbc.com/id/27005436.
163 *Id.*
164 *Id.*
165 *See* Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. TIMES (Oct. 2, 2008), https://www.nytimes.com/2008/10/03/business/03sec.html.
166 *Id.*
167 *See* U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 158.
168 *See* Labaton, *supra* note 165.
169 *Id.*
170 *See id.*
171 *Id.*
172 Carney, *supra* note 161.

private-label mortgage securities and a huge buildup of mortgage-related risk on the balance sheet of commercial banks."[173]

PART 4: PREDICTING THE FUTURE WITH LESSONS OF YESTERYEAR

Since 2017, there has been a historic effort to reduce regulation[174] and it has become imperative to look back and learn from the successes and failures of past eras of similar action. By looking at the approaches taken and subsequent outcomes of historical deregulation efforts in financial markets one can gain a better understanding of what works and what does not. This Part analyzes the three proposed deregulatory changes presented in Part 2 using the lessons learned from deregulation of past eras. Those analyses are used in support of conclusions as to the likely outcomes if each of the current era's proposals were to be enacted.

4.1 – An End to Quarterly Reporting Would End Market Efficiency & Be Struck Down

"For several decades now the majority view has been that, in theory, the cost-benefit analysis of mandatory disclosure in federal securities regulation is a favorable one . . . ., mandatory disclosure should make investors and firms collectively better off."[175]

The various proposals to end the historical practice of quarterly reporting for public companies would likely lead to significant market inefficiencies and increased rates of more severe fraud. Since the inception of investment market regulation in the United States, diligence via disclosure has been the cornerstone upon which the modern regulatory framework was built. In fact, "[t]he Securities and Exchange Commission has consistently held that adequate disclosure is fundamental to a fair and efficient capital market."[176] Even in recent years, the SEC Chairman has stated that "[d]isclosure is at the heart of our country's and the SEC's

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173 *Id.* (citing Jeffrey Friedman & Wladmir Kraus, ENGINEERING THE FINANCIAL CRISIS: SYSTEMIC RISK AND THE FAILURE OF REGULATION (2011)).

174 THE COUNCIL OF ECON. ADVISERS, THE ECONOMIC EFFECTS OF FEDERAL DEREGULATION SINCE JANUARY 2017: AN INTERIM REPORT 1 (June 2019), https://www.banking.senate.gov/imo/media/doc/The-Economic-Effects-of-Federal-Deregulation-Interim-Report.pdf.

175 de Fontenay, *supra* note 45, at 473 (citing Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1339 (1999)).

176 Allen et al., *supra* note 94, at 275.

approach to both capital formation and secondary liquidity."[177] However, if enacted, bringing an end to substantive quarterly reporting would spare marginal corporate reporting costs at the expense of the valuable market efficiency attributable to informed investors.

Ending quarterly reporting would also be disregarding nearly fifty years of economic theory that the function of investment markets is to allow capital to be put to its most productive use in an efficient manner. However, investors' ability to identify what the most productive use would be cut in half because of the new six-month reporting schedule. Even if the most productive place to deploy capital could be identified, redistribution would theoretically occur half as often because of the extra ninety-day delay on the availability of substantive information; thus, reducing the second prong of efficient manner as well. Not to mention, the suggestion of press-release styled information is a bit less than innovative genius than it is current reality in practice. While admittedly over-disclosure can have downfalls, and as stated in the regulation itself, "[t]here is . . . a possibility that high levels of immaterial disclosure can obscure important information or reduce incentives for certain market participants to trade or create markets for securities."[178] Nevertheless, disclosure of material items is required for a reason. Simply saying investors are too stupid to read or understand the material provided in quarterly disclosures (which are commonly fewer pages than this comment) is not only an illogical rationale for deregulation but also flips a middle finger to the same Main Street investors the Commission is funded to serve. Moreover, a reduction in reporting would remove regulation which provides economic benefit, not economic cost. The cost-benefit analysis of reporting has favored mandatory disclosure for decades.[179] Disregarding years of facts and data when making regulatory decisions that affect trillions of dollars would be as illogically dangerous as trying to avoid nuclear war via Twitter.

On top off inefficiency, losing the transparency provided by quarterly reporting would likely increase the average length and severity of corporate fraud. One of the most prominent accounting firms in the world, E&Y, has explained to the Commission that, "[q]uarterly reporting also helps reduce risks in the corporate financial reporting system by

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177 Jay Clayton, *Remarks at Meeting of the Investor Advisory Committee*, U.S. SEC. & EXCH. COMM'N (Dec. 13, 2018), https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-meeting-121318.

178 Business and Financial Disclosure Required by Regulation S-K, 81 Fed. Reg. 23916, 23919 (Apr. 22, 2016).

179 de Fontenay, *supra* note 45, at 473 (citing Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1339 (1999).

facilitating timely identification and resolution of potential accounting and reporting issues."[180] A stark example of the potential for negative results around decreases in disclosure requirements was seen in the role that the CFMA played in the devastation surrounding Enron's collapse. In a similar fashion, bringing an end to quarterly reporting likely wouldn't be the direct cause of an increase in occurrences of fraud. However, just as Enron's fraud remained hidden for almost a year under the CFMA, it would likely allow fraud to go unnoticed for longer periods than would happen under the current reporting regime. By cutting available information essentially in half, investors would "be nearly powerless to overcome their informational and bargaining disadvantages," which wouldn't be capable of being alleviated via administrative review or judicial deterrence due to the same general lack of information.[181] In the end, history suggests the various proposals to decrease mandatory disclosure would lead to market failures.

4.2 – Harmonization Initiative: Approach with Caution, Risk Ahead

"*The Securities Act, as deconstructed, turns out to be a malleable vessel into which a newly emerging deregulatory philosophy is being poured*."[182]

The SEC's proposal to harmonize offering exemptions is likely to result in a mix of the desired direct effects and indirect consequences if enacted without a narrower focus toward small issuers. With the potential to have a significant impact, the Harmonization Initiative's plan certainly would reduce complexity, eliminate economic costs to issuers, and increase availability of private capital. However, the potential uptick of capital being deployed in riskier ventures, lack of substantive effectiveness in relation to small issuers, and furthering decline of public market opportunities raise red flags that should be addressed prior to any enactment.

Encouragingly, altering the regulatory framework for raising capital in order to reduce complexity while still maintaining some level of required compliance has proven to be a successful method of market deregulation. The allowance for shelf registration by Rule 415 is evidence

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180 Ernst & Young, *supra* note 44, at 5. Ernest and Young went on to further express their support for retaining quarterly reporting for all domestic registrants, because the transparency it provides benefits investors, and it has contributed to making the US public capital markets so successful. E&Y believes "quarterly reporting minimizes information asymmetry between management and investors and reduces market uncertainty."

181 Palmiter, *supra* note 21, at 6.

182 *Id.* at 2.

of that concept. Similar to Rule 415, harmonization would eliminate offering complexities while still requiring a certain level of disclosure under its new simplified framework. While shelf registration did lead to isolated losses for underwriters in its early days, it evolved with syndication that could diversify risk and has become a popular offering method that is still used today. There is no reason to believe that the Harmonization Initiative, if put into practice, couldn't do the same.

In the longer-term, however, history suggests that Harmonization will further the decline of opportunities in public investment markets in favor of their private counterparts. While easing regulatory burdens in private markets is "arguably the most significant development in securities regulation of the last thirty years," its indirect effect on the decline of public markets has gone largely unaddressed.[183] "This is a critical and surprising omission, because the changes to the private side of securities regulation bear directly on a company's decision to go public."[184] With today's private markets flush with cash, companies lack the traditional incentives to go to public markets for capital and the majority of investors are only let in when companies decide to cash in. Even after the SEC's concept release, Chairman Clayton admitted to the harm of this trend by pointing out that, "our public markets are being used more for liquidity than for growth"—this is an issue.[185] Nevertheless, by providing further quantitative relief from regulatory burdens, the Commission's Harmonization Initiative would likely only further the decline of new public market investment opportunities.

Moreover, the Harmonization Initiative may also indirectly increase the amount of capital deployed in riskier investments—a result that has proven disastrous in the past. One need not look further back than 2008 to see the destructive effect that heavy investment in riskier ventures can cause. Similar to the way that GLB and the alternative net capital rule allowed massive amounts of capital to flow into risky derivatives, harmonization would ease the flow of capital into private, and typically unproven small companies. Even more alarming is the fact that, while so few cared to assess the health of their mortgage-backed investments pre-2008, private market investors would have little way of doing so even if they wanted to due to the decreased transparency in non-public markets. That increased risk-taking with a lack of transparency is what history urges we approach with caution against making the same mistakes again.

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183 de Fontenay, *supra* note 45, at 466.

184 *Id.*

185 CNBC, *Clayton: Individuals, institutions play by the same rules in public markets*, CNBC (Sept. 19, 2019, 10:00 AM), https://www.cnbc.com/video/2019/09/19/delivering-alpha-clayton-ross-sorkin-squawk-box-private-public-markets.html?&qsearchterm=jay%20clayton.

4.3 –Adding Accredited Investors Will Balance Access, Not Quality:

Addressing the problem of investor access, by potentially altering a definition that has gone nearly unchanged for almost forty years, the proposal will too chip away at the longstanding partition between public and private investment markets. Such willingness embodies the historical success of slowly lifting regulatory burdens in favor of free market efficiencies.

Similarities in the potential for financial innovation between the proposed accreditation expansion and 1975's Mayday inspires confidence. First, the proposal would directly allow for hundreds of thousands of retail investors to access the seemingly endless investment opportunities in private markets. With the recent examples of overwhelming returns from private market unicorns, where public market participants weren't getting in on the proverbial ground floor, the proposal would allow such opportunities almost immediately.

Second, the ancillary effect of increased innovation by small private issuers could be overwhelmingly positive for retail investors. Indeed, the financial market's innovative boom after Mayday admittedly took time to reach retail investors, but with time it fostered competition that created greater options and opportunities when it came to small investors. Expanding the accredited investor pool has similar potential in a slightly more direct route. It would also increase capital available for some smaller issuers which may have not been able to catch the eye of private equity and venture capital firms.

Nevertheless, the proposed expanded definition would likely not change the decision-making of offering issuers whose first preference is private investment firms. Regulators have acknowledged the negative impact "if the growth opportunities have shifted into our private markets and ordinary investors don't have access to them."[186] The opportunities awaiting them in private markets are unlikely to be of the best quality anyways. With a seemingly endless stream of private equity and venture capital money, newly accredited individual investors will likely only be offered access to lower-grade opportunities that large firms previously rejected. But even if the pitches that would be made to newly accredited individuals offer less monetary potential, the concerns of increased fraud in private offerings where less-wealthy investors are involved isn't supported by any evidence that the frequency of fraud in private markets is affected by the monetary thresholds for accredited investors.[187]

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186 CNBC, *supra* note 185.

187 *See Recommendations Regarding the Accredited Investor Definition*, *supra* note 72, at 2.

CONCLUSION

*"**We conclude this financial crisis was avoidable. The crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire. The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks . . . . To paraphrase Shakespeare, the fault lies not in the stars, but in us**."*[188]

The three deregulatory proposals of recent years each have the potential to meaningfully change a respective aspect of investment markets in some way. Although when looking at each through the lens of historical examples the likely outcomes are considerably different. An end to public company quarterly reporting requirements would remove the unquantifiable value of efficiency informed investors and will likely lead to prolonging fraud, just as historically shown with CFMA. Whereas, by taking certain unnecessary complexity away from portions of the offering exemption framework could have positive results, but the broad nature of the changes would likely lead to indirect and unintended consequences down the road. Independently significant is the likelihood for successful integration of individuals into private markets through the accreditation expansion proposed within the same concept release.

Financial markets have been constantly changing for decades and, while the rules must change as well, assuming the fundamental impacts of deregulation would be different this time could be a pricey—yet avoidable—mistake. It's history that provides the lessons in avoidance of future missteps. Yet somehow, historical warning signs are all too often disregarded for the impractical belief that this time is different somehow. But history doesn't only teach the last second warning signs, it provides the blueprints on what worked and why just as it does for those that didn't end up so well. The problem is not that the answers are not there for us—the problem simply is us, our willingness to look, and our stubbornness to admit we got it wrong. While each proposed example of deregulation has clear goals that project positive outcomes, it would be unwise to ignore the past results of similar concepts. Because this time—it's not different.

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[188] Fin. Crisis Inquiry Comm'n, *supra* note 130, at xvii (emphasis added).