Reconsidering Disclosure and Liability in the Transatlantic Capital Markets

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Abstract

In response to the current global financial crisis, governments around the world are introducing some of the most significant changes financial regulation since the Great Depression. However, these efforts fail to fundamentally alter the current overreliance on disclosure and fail to achieve international cooperation in deterring the next financial crisis. The article explores some of the limits of disclosure as a basis for financial regulation and to suggest international regulatory coordination of liability standards to help curtail the risky behavior that often leads to the pattern of boom and bust in the global financial markets. The purpose of this article is to evaluate previous research that challenges the assumption that disclosure of information forms a sufficient basis for regulating securities as well as call for more rigorous enforcement of existing laws and cooperation on standards of liability by regulators in the United States and the European Union.
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The history of global finance since 1980 has . . . been one of frighteningly expensive financial crises—expensive not just in terms of the costs to the taxpayer or of output foregone, but in terms of the shattered lives of innocent victims.¹

Introduction

In response to the global recession, governments around the world are introducing financial regulation reforms and pledging increased global coordination of regulatory efforts. While these reforms will introduce some of the most significant changes financial regulation since the Great Depression, they fail to fundamentally alter the current overreliance on disclosure and fail to achieve international cooperation in deterring the next financial crisis. This article aims to explore some of the limits of disclosure as a basis for financial regulation and to suggest international regulatory coordination of liability standards to help curtail the risky behavior that often leads to the pattern of boom and bust in the global financial markets. The purpose of this article is to evaluate previous research that challenges the assumption that disclosure of information forms a sufficient basis for regulating securities as well as call for more rigorous enforcement of existing laws and cooperation on standards of liability by regulators in the United States (US) and the European Union (EU).

The United States and the United Kingdom (UK), along with the other member states of the European Union, have explored a number of measures to deter future financial crises. Such cooperation builds upon previous commitments to cooperate on financial regulation. Following the wave of corporate scandals in the early 2000s, including those involving Enron, WorldCom and Parmalat, the Committee of European Securities Regulators (CESR)² and the United States Securities Exchange Commission (SEC)³ have pledged to pursue convergence of norms, standards and regulations in the transatlantic capital markets to achieve the creation of a barrier-free market.⁴ A true transatlantic market in securities⁵ supervised by regulators on both

¹ Martin Wolf, FIXING GLOBAL FINANCE: HOW TO CURB FINANCIAL CRISSES IN THE 21ST CENTURY (2009), 1.
² CESR is composed of the national securities regulators of the EU as well as Norway and Iceland. CESR has the responsibility of issuing standards and guidance for national regulators to implement. In contrast to the U.S. SEC, CESR does not have enforcement powers over securities issuers.
³ Founded by the U.S. Congress in 1934, the Securities Exchange Commission has the task of enforcing securities laws, promoting stability in the securities markets and protecting investors. See "The Investor’s Advocate: How the SEC Protects Investors and Maintains Market Integrity available at http://www.sec.gov/about/whatwedo.shtml (last visited October 2, 2010).
⁵ The academic literature offers two means of harmonization. See Eric J. Pan, Harmonization of U.S.-EU Securities Regulation: The Case for a Single European Securities Regulator, 34 LAW & POL’Y INT’L BUS. 499, 504. First, the EU and the U.S. could pursue harmonization by implementing mandatory rules applicable to all issuers. Id. Second, regulatory competition in which both the EU and the U.S. permit issues to select the regime which is most efficous could also achieve harmonization. Id. at 504-505 citing, inter alia, Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L.J. 2359 (1998), Stephen J. Choi and Andrew T. Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 CAL. L. REV. 903 (1998)
sides of the Atlantic and other marketplace actors could greatly enhance efficiency. However, in addition to working toward convergence in national disclosure standards which form the basis of securities regulation in both the U.S. and the EU, cooperation on enforcement and levels of liability for wrongdoing could greatly enhance investor protection. In particular, governments should agree on common liability standards which can dis-incentivize overly risky behavior.

In Part I, this article will briefly survey the current financial regulatory environment in the U.S. and in the EU, with an emphasis on the United Kingdom. In Part II, the article will summarise the weaknesses of disclosure as the basis of a securities regulation regime. Thereafter, this article will survey international efforts to regulate securities as well as make proposals to extend cooperation from the formulation of international disclosure standards to the setting of liability standards as well as enforcement of such standards by national regulators.

**Part I: Current financial regulation in the U.S. and EU**

**A. United States**

In the United States, the SEC has the authority to regulate the securities markets, and both federal and state laws form the legal framework for regulating the sale of securities. In the aftermath of the Great Depression, the United States adopted a securities regulations system based on mandatory disclosure and registration. The system has been summarized as follows:

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Experts have even call for a single European regulator to act in conjunction with the SEC. See generally Pan, supra note 5. Currently, the regulators in Europe are national, including among others, the Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)) in Germany and the Financial Services Authority (FSA) in the United Kingdom.


Iris H-Y Chiu, *Delegated Regulatory Administration in Mandatory Disclosure—Some Observations from EU Securities Regulation*, 40 INT’L LAW. 737, 739 (2006) (noting that “[t]he mandatory disclosure regulation for public offers is a foundational form of securities regulation, whether in the United States or in the EU.” Id.)


State laws are called “blue sky laws.” See generally HAROLD S. BLOOMENTHAL AND SAMUEL WOLF, SECURITIES AND FEDERAL CORPORATE LAW, 3E, §26 (2d ed. 2004). The term “blue sky” denotes the purpose of state securities laws: they are designed to prevent “speculative schemes which have no basis than so many feet of blue sky.” Id. at §26; quoting Hall v. Geiger-Jones C., 242 U.S. 539, 37 S. Ct. 217, 61 L. Ed. 480 (1917).

See generally Loss & Seligman, supra note 9, at 9-56 (describing the development of state and federal law).


See generally Loss & Seligman, supra note 9, at 114-180 (describing the procedure and contents for registration of securities).
The logic is that by arming investors with information, mandatory disclosure promotes informed investor decision making, capital markets integrity, and capital markets efficiency. Once they are empowered with information, the argument goes, investors can protect themselves against corporate abuses and mismanagement, and there is no need for the government to engage in more substantive securities regulation—merit review in the parlance.\(^{15}\)

This disclosure-based regime is built on the premise that providing investors with all material information will lead to the most rational investment decisions and in the long-run, the highest levels of efficiency in the capital markets.

Financial regulation has depended on whether a particular instrument constitutes a “security” in which case regulation falls with the SEC’s remit.\(^{16}\) Financial instruments which do not fall within the concept of a security are supervised by other regulators, most notably the Commodities and Futures Trading Commission (CFTC), which has had some authority for regulating derivatives. The regulation of banking activities is not within the authority granted to either the SEC or the CFTC, and as such fall outside the scope of this article.\(^{17}\) With widespread disagreement on how to classify credit derivatives—\(^{18}\) the instruments which lay at the heart of the subprime mortgage crisis—has caused difficulty in assigning regulatory responsibility for regulating such financial instruments. In the wake of the subprime mortgage crisis, efforts are under way to clearly assign joint responsibility to the CFTC and the SEC to regulate derivative financial instruments. The lack of regulatory supervision for derivative instruments illustrates the damaging consequences of financial innovation that is not suitably regulated. The US’s rule-based system\(^{19}\) applies not only to U.S. companies but also extraterritorially to non-U.S. issuers.\(^{20}\)

Several federal statutes form the basic regulatory framework, including the Securities Act of 1933 (the “Securities Act”),\(^{21}\) the Exchange Act of 1934 (the “Exchange Act”),\(^{22}\) the Trust Indenture Act of 1939,\(^{23}\) the Investment Company Act of 1940,\(^{24}\) the Investment Advisors Act of 1940,\(^{25}\) the Sarbanes-Oxley Act of 2002.\(^{26}\) Due to

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\(^{16}\) See generally Loss & Seligman, *supra* note 9, at 201-277 (discussing the statutory definition and judicial interpretation of the term “security”).

\(^{17}\) For an analysis of the tension between the regulatory authority of the SEC and U.S. banking regulators, see generally Eugene F. Maloney, Banks and the SEC: A Regulatory Mismatch, 25 ANN. REV. BANKING & FIN. L. 443 (2006) (arguing that the SEC and banking regulators should work together to improve the oversight of banking securities activities and enhance investor protection).


\(^{21}\) 15 U.S.C. §§ 77a-77aa, as amended.

\(^{22}\) 15 U.S.C. §§ 78a-77jj, as amended.


the wide he current paper focuses only on the Securities Act, the Exchange Act, the Sarbanes-Oxley, and the Dodd-Frank Act.27

1. Securities Act

The Securities Act regulates the initial distribution of securities by an issuer.28 With certain limited exceptions,29 Section 5 of the Securities Act makes it illegal for any person to offer to sell or buy any security unless the security is registered with the SEC.30 The SEC regulates the sale of securities through requiring issuers to disclose certain information, rather than examining the offer itself31 or “substantively regulating corporate behavior.”32 Depending on the type of issuer, or transaction, the securities laws require different registration forms and levels of disclosure.33 Regardless of the issuer or transaction, however, the issuer must describe its financial condition, operating results as well as other matters related to its business.34 Since 1998, the SEC has enforced its “Plain English” rule that requires financial reports and offering documents to be written in a manner that is clear, precise and accessible to investors.35

If the registration statement36 contains any material misstatement of fact or material omission,37 the purchaser has a cause of action against the issuer and its directors, the underwriters of the offering, each person who signed the registration statement and each expert (which includes accountants, engineers and appraisers) who prepared and

27 The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, H.R. 4173 (2010). The statutes not included herein regulate interstate holding companies concerned with trust indentures which publically issue more than $5 million worth of debt securities (Trust Indenture Act of 1939); companies which either have the primary purpose of investing securities or hold, trade, invest, reinvest or own certain securities which account for more than 40% of the value of their assets (Investment Company Act of 1940); and investment advisors who give advice on securities if not incidental to a brokerage business (Investment Advisers Act of 1940).
28 See generally Loss & Seligman, supra note 9, at 38.
29 Exemptions exist for both transactions and particular types of securities. The most common transaction exemptions from registration include Section 3(a)(11) Rule 147 which allows intrastate offers and sales only; Rule 506 of Regulation D which allows for private placements, i.e., where no public offer is made; Rules 504 and 505 of Regulation D which allow for offerings of no more than $1 million and $5 million, respectively; and Regulation S which allows for offers and sales outside the United States. Securities issued or guaranteed to by federal, state or municipal governments are exempt as well those issued by not-for profit organizations, those maturing in less than nine months, those which are part of a reorganization plan under bankruptcy and those which are exchanged for no associated commission pursuant to an exchange exclusively with existing holders by the issuer are all exempt according to Section 3(a)(9).
30 See generally Loss & Seligman, supra note 9, at 82-114.
33 See generally Loss & Seligman, supra note 9, at 139. The SEC has requires different levels of disclosure based on whether the issuer is a U.S. or non-U.S. issuer. Id.
34 In particular, each registration statement requires a management discussion and analysis section. See generally Greene et al., supra note31, at 2-119.
36 For further details on the contents of registration statements, see Loss & Seligman, supra note 9, at 138-144.
37 § 11(a) Securities Act of 1933; see generally Loss & Seligman, supra note 9, at 1149-1152.
consented to be named in the registration statement.\(^{38}\) Such liability provisions are severe and are designed to convey all relevant details to the markets and investors. However, as will be shown in Part II, such a disclosure-based approach is not necessarily effective in deterring the type of behaviour the led to the financial crises of the past and that are likely to lead to potential crises in the future.

2. Exchange Act

The Exchange Act regulates securities traded in the secondary market after initial distribution.\(^{39}\) Under the Exchange Act, issuers with securities that are either listed on a U.S. national exchange or quoted on Nasdaq\(^{40}\) or have 500 or more shareholders of any class of equity securities and greater than $10 million in assets\(^{41}\) must file periodic reports\(^{42}\) with the SEC. Further, issuers which engage in a public offer of debt or equity securities in the U.S. are required for a year (or thereafter as long as there are 300 persons or more holding the shares) to file periodic reports.\(^{43}\) Recognized as the primary remedy for violations,\(^{44}\) Section 10(b) of the Exchange Act prohibits the use of any manipulative or deceptive device in interstate commerce in the sale or purchase of a security.\(^{45}\) Promulgated pursuant to §10(b) of the Exchange Act, Rule 10b-5\(^{46}\) makes it unlawful to use any direct or indirect means of interstate commerce or to employ any deceptive or manipulative device, or make any material untrue statement or material omission in connection with the purchase or sale of any security.\(^{47}\)

3. Sarbanes-Oxley Act

Following Enron’s spectacular financial meltdown\(^{48}\) and the litany of other financial scandals that rocked markets around the world at the dawn of the 21\(^{st}\) Century,\(^{39}\) the

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\(^{38}\) Id. at 1152. Several statutory provisions grant remedies for misleading or fraudulent disclosures, including §§ 8, 11, 12(a)(2) and 17 of the Securities Act. See generally Greene et al., supra note 4, at § 14.03 (7th ed., 2004).

\(^{39}\) See generally Loss & Seligman, supra note 9, at 435.

\(^{40}\) Greene et al., supra note 31, at 1-8.

\(^{41}\) Following an initial public offer, issuers that do not meet these thresholds may also register as to facilitate trading on an exchange (or automated quotation system such as Nasdaq).

\(^{42}\) For its annual report, quarterly report and current report (for any material event or corporate change), a domestic issuer must file a Form 10-K, Form 10-Q and a Form 8-K, respectively, while a foreign issuer must file a Form 20-F, which is effective for both the Securities Act and the Exchange Act, and a Form 8-A is used if the issuer is registering under the Exchange Act in a public offer. See Greene et al., supra note 31, at § 3.03[1].

\(^{43}\) See generally Greene et al., supra note 31, at § 1.03.

\(^{44}\) Greene et al., supra note 31, at § 14.04[2].

\(^{45}\) See generally Loss and Seligman, supra note 9, at 839-840.


\(^{47}\) Loss & Seligman, supra note 9, at 962-976. See also Donald C. Langevoort and G. Mitu Gulati, The Muddled Duty to Disclose under Rule 10b-5, 57 Vand. L. Rev. 1639 (2004) (surveying the case law and discussing different disclosure duties in various contexts).


\(^{49}\) See generally Scott Green, A look at the Causes, Impact and Future of the Sarbanes-Oxley Act, 3 J. Int’l Bus. & L. 33, 34-46 (2004); John Plender, Problems at Ahold, Parmalat, and now Adecco raise new questions about how global accounting firms should work with multinationals and the risks of modern investment management techniques, Financial Times, Jan. 22, 2004, p. 15; and Tobias Buck,
U.S. Congress ("Congress") engaged in a feverish attempt\(^{50}\) to put into place new legal structures to increase investor protection.\(^{51}\) The Congressional reform efforts culminated in the adoption of the Sarbanes-Oxley Act\(^{52}\) ("SOX") in the summer of 2002. SOX is a far-reaching statute,\(^{53}\) which imposes significant new corporate governance, certification, disclosure and other requirements that directly impact U.S. and non-US\(^{54}\) companies with securities listed on national securities exchange in the U.S. (e.g., NYSE\(^{55}\) or Nasdaq\(^{56}\)).

SOX is the most significant statute relating to securities regulation over the past several decades.\(^{57}\) It provides for a significant regulatory regime for accountants including independence, certification and attestation requirements as well as requiring the establishment of an accounting oversight board called the Public Accounting Oversight Board (the "PCAOB").\(^{58}\) Further, Title III of SOX sets forth standards of corporate responsibility, including independence standards for audit committees.\(^{59}\) The increased disclosure\(^{60}\) and costs\(^{61}\) associated with SOX have caused much reluctance and opposition from foreign private issuers\(^{62}\) in particular.\(^{63}\) Many experts have harshly criticized Sarbanes-Oxley,\(^{64}\) arguing that "the corporate governance provisions of SOX are ill conceived."\(^{65}\) Although SOX imposes significant costs\(^{66}\) on all registered companies, and disproportionately affects foreign issuers,\(^{67}\) the

\(\text{Alarm spreads as virus across the pond, \textit{FINANCIAL TIMES}, December 24, 2004, FT Report: Corporate Governance, p. 2.}\)

\(\text{50} \) Roberta Romano, \textit{The Sarbanes-Oxley Act and the Making of Quack Corporate Governance}, 114 YALE L. J. 1521, 1523-1524 (2005).

\(\text{51} \) See Shirinyan, \textit{supra} note 12, at 524.


\(\text{54} \) For foreign issuers in particular, SOX has resulted in significant direct and indirect costs to issuers as well as to their advisers and the exchanges upon which they list. See Shirinyan, \textit{supra} note •, at 525 (2004). See also Naidu \textit{supra} note 20, at 277.

\(\text{55} \) The New Stock Exchange (the “NYSE”) is the largest auction marketplace in the world. See \textit{generally} http://www.nyse.com/ (last visited October 2, 2010).

\(\text{56} \) See \textit{generally} http://www.nasdaq.com/ (last visited October 2, 2010) Operated under the supervision of the National Association of Securities Dealers (NASD), the Nasdaq Stock Market (“Nasdaq”) is the securities market formerly operating under the name the “National Association of Securities Dealers Automated Quotation System.” Securities are quoted on Nasdaq (rather than listed). See “Over-the-Counter Markets” available at http://www.sec.gov/divisions/marketreg/mrotc.shtml (last visited October 2, 2010).

\(\text{57} \) Gara and Langstraat, \textit{supra} note 53, at 74.

\(\text{58} \) Blumenthal & Wolff, \textit{supra} note 10, at §§ 30:5-30:17.

\(\text{59} \) Sarbanes-Oxley, §§ 301-308.


\(\text{63} \) See \textit{generally} Anupama, \textit{supra} note 20.

\(\text{64} \) See \textit{generally} Romano, \textit{supra} note 50, at 1521, 1528 and Ribstein, \textit{supra} note 60.

\(\text{65} \) Romano, \textit{supra} note 50, at 1528.

\(\text{66} \) See \textit{generally} Ribstein, \textit{supra} note 60, at 35-45 and Romano, \textit{supra} note •, at 1588.

\(\text{67} \) The SEC received a number of comment letters regarding SOX’s impact on foreign issuers. See \textit{generally} Comments of Organization for International Investment on S7-21-02 (Aug. 19, 2002) at http://www.sec.gov/rules/proposed/s72102/tmmalan1.htm (last visited October 2, 2010) (discussing the
additional layers of protections offered by SOX cannot ensure ethical behavior and history indicates that unethical companies simply will become more creative in thwarting new regulations.

4. Dodd-Frank Act

On July 21, 2010, President Obama signed The Dodd-Frank Wall Street Reform and Consumer Protection Act, which contains wide provisions for regulating the financial markets. Among other changes, The Dodd-Frank Act establishes the Financial Stability Oversight Council, whose purpose is to identify risks to the U.S. financial stability, promote marketplace discipline, and respond to threats to financial stability. In response to criticisms against companies considered “too big to fail,” the Act creates a mechanism through an “orderly liquidation authority” that allows the Federal Deposit Insurance Corporation to take control over financial institutions whose collapse might threaten the entire U.S. economy. The Act also introduces new regulatory measures related to the hedge fund and private equity industries as well as adjusts the standards for an “accredited investor.” In addition to creating the Federal Insurance Office within the Department of the Treasury to monitor most lines of insurances, the Act also introduces stricter regulation, oversight, and enforcement powers over depository institutions and their subsidiaries. Further, the Dodd-Frank Act assigns primary regulatory responsibility to the Commodity Futures Trading Commission (CFTC) and the SEC to regulate the swaps market and other aspects of the derivative industry. The Act also increases regulation of financial market utilities and institutions engaged in payment, clearing, and settlement activities as well as enhancing regulatory requirements relating to broker-dealers, credit rating agencies, structured finance products, executive compensation and corporate governance. Further, the Act introduces changes at the Federal Reserve, including

extremely high level of liability SOX §304 could impose on officers of foreign private issuers) and Comments of European Commission on S7-02-03 (Feb. 18, 2003) at http://www.sec.gov/rules/proposed/s70203/aschaub1.htm (last visited October 2, 2010) (discussing the potential conflicts of law between SOX and laws of the European Union and the difficulty European issuers may face in complying with both).

68 See generally Larry E. Ribstein, Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. CORP. L. 1, 61 (2002). With regard to corporate governance, Enron itself appeared to be a model of good corporate governance before it unravelled. See generally Ronald B. Davis, Fox in S-OX North, A Question of Fit: The Adoption of United States Market Solutions in Canada, 33 STETSON L. REV. 955, 968 (2004). Professor Davis points out the limitations of corporate governance: “On the one hand, the board of directors is the only existing device for monitoring managers. On the other, more and less sympathetic observers of boards of directors have come to acknowledge what should have been obvious all along: The traditional corporate solution of introducing outside directors to bridge the separation between ownership and control has dramatic limitations.” Id. at 970-971 citing Ronald J. Gilson and Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, STAN. L. REV. 863, 876 (1991).

69 Greene et al., supra note 31, at 49.


71 See id. at Title I: Financial Stability.

72 See id. at Title II: Orderly Liquidation Authority.

73 See id. at Title IV: Regulation of Advisers to Hedge Funds and Other Institutions.

74 See id. at Title V: Insurance.

75 See id. at Title VI: Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions.

76 See id. at Title VII: Wall Street Accountability and Accountability.

77 See id. at Title VIII: Payment, Clearing, and Settlement Supervision.

78 See id. at Title IX: Investor Protections and Improvements of the Regulation of Securities.
limiting its authority to engage in emergency lending\(^\text{79}\) as well as the creation of the Bureau of Consumer Financial Protection to issue rules applicable to financial institutions that offer financial products and services to consumers.\(^\text{80}\) Additionally, the Act enables the Secretary of the Treasury to establish programs aimed at improving access for underserved communities to financial products\(^\text{81}\) and contains amendments to the American Recovery and Reinvestment Act of 2009 passed in response to the financial crisis precipitated by the failure of the subprime loan industry that relate to repayment of emergency funds extended to financial institutions.\(^\text{82}\) Finally, among its other provisions, the Act increases disclosure obligation requirements relating to residential mortgage loans.\(^\text{83}\)

5. Other regulators

The U.S. Congress created the CFTC in 1974 to regulate commodity futures and option markets in the United States. Although its original mandate largely concerned the agricultural sector, a series of legislative actions, most notably the Commodity Futures Modernization Act of 2000 and most recently the Dodd-Frank Act, has increased its regulatory remit significantly. The CFTC works to encourage competitiveness and efficiency in the futures markets, to help protect market participants from manipulation, fraud, and abusive trading practices, and to ensure the financial integrity of clearing processes\(^\text{84}\).

Self-regulatory organizations (“SROs”) have an important role in monitoring the capital markets in the United States.\(^\text{85}\) These non-governmental entities, including the New York Stock Exchange (“NYSE”) and the National Association of Securities Dealers, Inc. (“NASD”), work in concert with the SEC and act with quasi-governmental authority to adopt rules for the enforcement of federal securities laws.

5. Enforcement and liability

Enforcement of securities laws in the U.S. is largely posited on mandatory disclosure and antifraud rules. Both Sections 11, Sections 12(a)(2) and Section 17(a) all allow for liability for failures to disclose all material facts.\(^\text{86}\) These and other similar provisions “are designed to work hand-in-hand to protect investors and promote market integrity.”\(^\text{87}\) In addition, Section 10 of the 1934 Act\(^\text{88}\) as well as Rule 10b-5\(^\text{89}\)

\(^{79}\) See id. at Title XI. Federal Reserve System Provisions.

\(^{80}\) See id. at Title X. Bureau of Consumer Financial Protection.

\(^{81}\) See id. at Title XII. Improving Access to Mainstream Financial Institutions.

\(^{82}\) See id. at Title XIII. Pay it Back Act.

\(^{83}\) See id. at Title XIV. Mortgage Reform and Anti-Predatory Lending Act.


\(^{86}\) In TSC Indust., Inc. v. Northway, Inc., 426 U.S. 438 (1976), the U.S. Supreme Court addressed the meaning of the term “material” in the following manner: “An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” Id. at 449.

\(^{87}\) Joan MacLeod Heiminway, Personal Facts about Executive Officers: A Proposal for Tailored Disclosures to Encourage Reasonable Investor Behavior, 42 WAKE FOREST L. REV. 749, 753 (2007).


\(^{89}\) 17 C.F.R. §240.10b-5 (2004).
further provide for liability for failures to disclose all material facts. The United States Private Securities Litigation Reform Act of 1995 was designed to offer protection against frivolous lawsuits. The so-called fraud-on-the-market theory has been the general presumption in U.S. securities litigation since the Supreme Court’s decision in Basic v. Levinson guiding shareholder class action suits in the U.S. and is posited on the efficient market hypothesis, which broadly assumes that stock values always reflect all relevant information and therefore trading on exchanges always reflects the stock actual value. A plaintiff may also rely on the common law theory of deceit, although more difficult to prove in practice.

The SEC’s Division of Enforcement has the authority to investigate alleged securities violations, and it may bring an action in federal court or through an administrative proceeding. While the SEC’s statutory purpose is to deter violations and provide remedial relief to aggrieved investors, its enforcement actions have becoming punitive over the past two decades. The penalties are significant, including an injunction prohibiting the improper conduct, disgorgement of ill-gotten gains, civil monetary penalties, a prohibition against a person serving as an officer or director in a public company and suspension from practice before the SEC. However, the SEC has no authority to bring a criminal case against a defendant, but it may recommend that the Department of Justice prosecute a defendant in a criminal proceeding. Private parties as individuals or in a class action lawsuit may seek injunctive relief or monetary damages for some federal securities law violations. Although the U.S. Supreme Court has not determined whether the provision provides a private cause of action, the provision grants the SEC significant power to pursue wrongdoing.

B. The European Union and the United Kingdom

In the context of creating a true internal market, the EU seeks to eliminate all barriers to the free movement of goods, services, people and capital among the EU member states according to the terms of the Treaties forming the European Union. The EU has worked toward further integration with the adoption of the Euro as the common currency among many of its member states, the establishment of the

92 See Frederick C. Dunbar and Dana Heller, Fraud on the Market Meets Behavioral Finance, 31 DEL. J. CORP. L. 455, 458 (2006). In describing the requirements to prove deceit in reliance on Greenwald v. Integrated Energy, 103 F.R.D. 65, 68 (S.D. Tex. 1984), the authors note that it requires “among other things, the following: (1) materiality—whether the misstatement or omission was important to a reasonable investor; (2) scienter—whether defendants acted with some degree of intent; (3) reliance—whether the investor’s decision to trade was affected by the omission or misstatement (also sometimes called transaction causation); and (4) loss causation—whether the misstatement or omission was the proximate cause of the loss to the investor.” Id.
93 Paul S. Atkins and Bradley J. Bondi, Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program, 13 FORDHAM J. CORP. & FIN. L. 367, 383 (2008). The authors point out that through Congressional legislation, “the SEC gained three significant new sets of powers: (1) the ability to seek civil monetary penalties against persons and entities that may have violated federal securities laws; (2) the authority to bar directors and officers of public companies from serving in those capacities if they violated federal antifraud provisions; and (3) the authority to issue administrative cease-and-desist orders, temporary restraining orders, and orders for disgorgement of ill-gotten profits to violators of federal securities laws.” Id. at 385.
95 For a discussion of the internal market and its development, see generally John F. Mogg, Regulating Financial Services in Europe: A New Approach, 26 FORDHAM INT’L J. 58 (2002).
European Central Bank, and the introduction of European citizenship. Nonetheless, the patchwork of securities regulations in Europe “lacks any sort of legal uniformity in terms of laws.” In an attempt to identify measures for promoting harmonization among the member states, the EU Economic and Finance Ministers appointed the Committee of Wise Men to investigate the regulation of the securities market in the EU. The culmination of the Committee of Wise Men’s work was the recommendation for the creation of the European Securities Committee (the “ESC”) and the Committee of European Securities Regulators (“CESR”).

Although the British Government has planned fundamental reforms to financial regulation, the principles which have underpinned the regulatory framework in the UK since late 1990s continue to be relevant. These principles have focused on the avoidance of duplication between the roles assigned to the each of the Tripartite Authorities (Financial Services Authority, Bank of England and Treasury); on achieving clarity of responsibility and of decision making; and on adequate structural flexibility enough to respond to increasingly complex, global and integrated financial services market place. The principles which inform the practice of regulation are a risk based approach, based on a balance between general principles and specific rules. The following discussion sketches the regulatory framework in the European Union, focusing on the United Kingdom in particular.

1. European Union

In order to achieve a greater degree of financial markets integration, the European Commission issued a plan in 1999 to further and more effectively harmonize EU securities laws, the Financial Services Action Plan (FSAP), which the Lisbon European Council endorsed in March 2000 to create the necessary regulatory environment to help achieve the integration of financial markets in the European Union by 2005. The FSAP was implemented through a number of legislative measures regulating or de-regulating financial services, securities markets, and corporate governance. A number of European directives form the securities

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98 See Final Report of the Committee of Wise Men at 28. The ESC is comprised of representatives from the member states while CESR is comprised of senior representatives from the member states’ securities regulators.
regulatory framework, including the Prospectus Directive,\(^{104}\) the Takeover Directive,\(^{105}\) the Transparency Directive,\(^{106}\) the Market Abuse Directive,\(^{107}\) and the Markets in Financial Instruments.\(^{108}\)

A. Prospectus Directive

As part of its effort to create a true pan-European securities regime and enhance consumer protection, the European Commission adopted the Prospectus Directive in July 2003. The Directive specifies the disclosure requirements relating to initial information for securities offered publicly or admitted to trading on a EU regulated market.\(^{109}\) As the Prospectus Directive is a “maximum harmonization” directive, the member states are not able to impose additional requirements regarding the content of a prospectus or when a prospectus is required on issuers from other member states.\(^{110}\) The importance of the Prospective Directive is that it provides a single platform for issuers to raise capital in the EU, and has created a far more harmonized European regime across the member states.\(^{111}\)

B. Takeover Directive

The Takeover Directive\(^{112}\) establishes a common EU framework to regulate takeover bids of companies whose securities trade on EU regulated markets. The Directive is modelled closely on the UK Takeover Code, which is strongly weighted toward protecting the shareholders’ interests.\(^{113}\) However, member states have implemented the Takeover Directive in different manners. These various national approaches have


\(^{109}\) The Prospectus Directive 2003/71/CE should be put in action by all EU Member states by July 1 2005 – see Jorge de Pereira and Sónia Teixeira da Mota, the Pros and Cons of the Prospectus Directive, 24 INT’L FIN. L. REV. 79 (2005).

\(^{110}\) See the Committee of European Securities Regulators, CESR’s Report on the supervisory functioning of the Prospectus Directive and Regulation, June 2007, 5; Edward F. Greene, Resolving regulatory conflicts, 2 CAPITAL MARKETS LAW JOURNAL, 5, 16 (2007).


hindered the development of a transparent and stable cross-border re-structuring environment.\textsuperscript{114}

\section*{C. Transparency Directive}

The Transparency Directive\textsuperscript{115} covers the content and regularity with which companies should report financial information and its appropriately disseminated to the market. The Transparency Directive became effective in the autumn of 2006. In contrast to the Prospectus Directive, the Transparency Directive is not a “maximum harmonization” directive; therefore, the member states are able to impose additional requirements on issuers incorporated in their respective countries. Further, exchanges are permitted to impose additional requirements on issuers which are traded on their respective markets. The Transparency Directive requires issuers of debt or equity securities traded on a stock market or other regulated market in the EU to publish within four months of the end of the financial year, file with the appropriate authority with the issuer’s home member state, and make publicly available in the EU, an annual report under IFRS or their equivalent and a responsibility statement by the board.\textsuperscript{116} Similarly, the Transparency Directive requires companies to issue half-year reports and using IAS 34 (or equivalent standards) within two months of the issuer’s financial half-year and be accompanied by a management report and a responsibility statement by the board. With regard to quarterly reports, the Transparency Directive requires companies to issue an interim statement explaining material events and transactions of the particular period and the impact of these events and transactions of the particular period and the impact of these events or transactions on the issuer’s financial condition. Additionally, the quarterly report must contain a general description of the issuer’s financial position and performance during the particular period. The Transparency Directive further requires the disclosure of significant changes in securities holdings as measured by voting rights beginning with 5% and thereafter at each 5% interval to 30%, then at 50% and finally at 75%.

\section*{D. Market Abuse Directive}

Effective since April 2003, the Market Abuse Directive sets forth regulations to address insider trader and market manipulation, affecting all firms and individuals participating in a regulated market in the EU. The primary requirements for firms are mandatory suspicious transaction reporting and preventative requirements for issuers and their advisers to keep lists of staff who have inside information. The Market Abuse Directive requires the dissemination of inside information as soon as possible in order to avoid market abuse. The Market Abuse Directive adopts a uniform definition of ‘inside information’ where information must be of precise nature, be price sensitive, not have been made public and related to issuer(s) of financial instruments or to financial instrument(s).

\textsuperscript{116} Such is similar to the CEO and CFO responsibility statements required by the Sarbanes-Oxley Act.
E. Markets in Financial Instruments Directive

The Markets in Financial Instruments Directive (MiFID)\textsuperscript{117} came into force in April 2004 and replaces the existing Investment Services Directive and regulate the authorisation and conduct of securities firms and markets. The purpose of MiFID is to promote cross-EU provision of investment services while protecting the investor and supporting market integrity.

2. United Kingdom

A. The Financial Services Authority

The Financial Services Authority (the “FSA”) is a single statutory regulator for financial services in the UK,\textsuperscript{118} resulting from the merger of the then existing nine regulatory bodies\textsuperscript{119} in response to the greater interdependence within the financial industry in which the boundaries between their businesses had blurred.\textsuperscript{120} The former Securities and Investment Board was renamed the Financial Services Authority in October 1997 and the supervisory responsibilities of the Bank of England were transferred to the FSA in June 1998, and the FSA became fully operational from 1 December 2001. Under the current regulatory regime, the Treasury, the Bank of England (BOE) and the FSA\textsuperscript{121} have distinct roles with the BOE is responsible for operating monetary policies whereas the FSA has responsibility for the overall institutional structure of the financial services regulation, including oversight of the London Stock Exchange.\textsuperscript{122} The Treasury is the government department responsible for developing and executing the Government’s public finance policy and economic policy. In the spring of 2010, the new coalition Government of the Conservatives and Liberal Democrats announced plans to reform financial regulation in the UK, which includes considering changing the current tripartite financial regulatory structure.


\textsuperscript{119} The Securities and Investment Board, the Personal Investment Authority, the Investment Management Regulatory Organisation, the Securities and Futures Authority, the Supervision and Surveillance Division of the Bank of England, the Building Societies Commission, the Insurance Directorate of the Department of Trade and Industry, the Friendly Societies Commission and, the Registrar of Friendly Societies.


\textsuperscript{121} HM Treasury, Financial Services, Regulating Financial Services available at http://www.hm-treasury.gov.uk/fin_rsf_index.htm (last visited October 2, 2010).

\textsuperscript{122} The FSA, under the Financial Services and Markets Act 2000(UK), has responsibility for supervising the London Stock Exchange, which has a two stage admission process: the company applies to the UK Listing Authority for admission to the Official List (\textit{see generally} section 74(1) of the FSMA 2000; London Stock Exchange Admission and Disclosure Standards – September 2009 available at http://www.londonstockexchange.com/companies-and-advisors/main-market/documents/brochures/admission-and-disclosure-standards.pdf (last visited October 2, 2010)) and to the LSE for admission to trading on the stock market.
The FSA has been strongly associated with a so-called “light touch” philosophy approach to regulating financial markets and exchanges, regulated activities, and other activities connected with financial markets and exchanges. In response to the financial crisis, many have criticized the FSA’s close relationship with financial institutions as a source of much regulatory arbitrage such that some of the serious money laundering occurring at banks in London. The FSA has set out four statutory regulatory objectives and several regulatory principles, including maintaining market confidence in the financial system, promoting public awareness of the financial system, securing consumer protection, and preventing the financial sector firms for being used for a purpose connected with financial crime. In fulfilling these objectives, the FSA is guided by the particular considerations, including efficient and economic use of resources; financial services firms’ management role in meeting regulatory responsibilities; principle that a burden or restriction on regulated activity should be proportionate to the benefit conferred; facilitation of innovation in the market; and maintenance of the UK’s competitive position.

B. The Financial Services and Markets Act 2000

Consolidating the previous main legislative regimes governing the marketing of deposits, insurance and investments, the Financial Services and Markets Act 2000 came into force from 30 November 2001 and provides a single flexible legislative framework, conferring extensive powers on the Treasury and the FSA to devise the details of the regulatory regime by secondary legislation. Part II of the Act sets forth the ‘general prohibition’ such that only an authorised or an exempt person may carry

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123 This “light touch” approach was often credited with London’s rapid growth in financial services prior to the subprime loan crisis, with the FSA’s principles-based approach attracting interest in response to a significant number of large international IPOs listing in London instead of New York. See Jenny Anderson, U.S. Financial Sector Is Losing Its Edge, Report Says, N.Y. TIMES, Jan. 22, 2007. It has been argued that the UK’s principles-based approach was the primary reason behind the shift rather than lax regulatory standards or the more stringent requirements under the U.S. Sarbanes-Oxley. The Chief Executive Officer of the London Stock Exchange, Clara Furse, argued that “London’s principles-based regime, rather than a more prescriptive rules-based approach, continues to prove itself as a model that facilitates pro-competitive innovation in a tough but sensible regulatory environment. All the important independent corporate governance surveys confirm that the U.K. is number one for corporate governance standards.” See Clara Furse, Comment: Sox is Not to Blame – London is Just Better as a Market, FINANCIAL TIMES, Sept. 17, 2006.

124 Financial Services and Markets Act 2000, s.3(2).


127 Financial Services and Markets Act 2000, s.3(1).

128 Financial Services and Markets Act 2000, s.4(1).

129 Margaret Cole, Director of Enforcement, FSA, The UK FSA: Nobody does it better? (October 2006).

130 See FSA, Financial Services Authority Meeting our responsibilities, available at http://www.fsa.gov.uk/pubs/policy/P05.pdf (last visited October 2, 2010). The FSA are fully committed to an open and responsive approach, for example allowing the establishment of a practitioner forum whose function is to monitor the extent to which the authority is meeting its statutory objectives.

on, or may purport to carry on a regulated activity from the UK. Under the FSMA, the FSA may impose disciplinary sanctions, including fines or public statements, for breaches of the Listing Rules.

3. The Bank of England, the Treasury and Future Reforms

The Bank of England has an independent role in setting monetary policies. Its role exists in the macroeconomic stability, whereas, the two microeconomic stability objectives of prudential supervision and investor protection are within the FSA’s regulatory regime. The Treasury has reserve powers to give orders to the Monitory Policy Committee of the Bank if they are required in the public interest and by extreme economic circumstances, but such orders must be endorsed by Parliament.

Chancellor Gorge Osborne is convinced that the tripartite system of regulation set up in 1997, which split the control of the Bank, the Treasury and the FSA, has been a contributory factor in the financial crisis problems in UK. Hence, the coalition Conservative-Liberal Democrat Government has considered plans to transfer the FSA’s powers for supervising banks to the Bank of England. Under such reforms, the Bank of England would have control of macro prudential regulation supervision, a big picture assessment of prevailing conditions in the UK financial markets, and supervision of individual banks.

4. Liability and Enforcement of UK and EU law

With its power to initiate financial sector regulation, the European Commission plays a fundamental role in the formulation and monitoring of financial regulation in the EU. Through 1999 and 2005, the Financial Services Action plan guided the European Commission’s initiatives, and since 2005, the While Paper on Financial Services has set the objectives, including soundly enforcing current rules, eliminating inconsistencies in regulation, and enhancing convergence among regulatory supervisors, promoting competition, and increasing the EU’s influence on global capital markets. The EU’s financial regulation is designed to support the single market. Named after Alexander Lamfalussy, the Lamfalussy framework endorsed by the European Council in 2001 provides a four level approach for the adoption of EU financial regulation. The first two levels relate to the creation of regulation, with level one denoting the adoption of legislation and level two referring to technical rulemaking led by the European Commission for the implementation of level one.

134 The Bank was previously responsible for regulating the banking industry until June 1998, when the FSA became responsible.
135 EU financial services policy for the next five years, EU press (ref. IP/05/1529), 5 December 2005-2010.
137 EU financial services policy for the next five years, EU press (ref. IP/05/1529), 5 December 2005.
legislation. Level three concerns the activities of the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR), and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) to encourage supervisory convergence and best practices. Level four denotes regulatory enforcement, chiefly by national supervisory authorities, although the European Commission monitors the application of legislation while the European Court of Justice hears allegations of infringements. Because of the complicated four level approach to financial regulation, the enforcement of liability standards for infringement of financial regulation varies across the member states of the European Union.

In the UK, shareholders can potentially sue directors both under the Financial Services Market Act 2000 and the common law to recover losses caused by false or misleading disclosure in documents supporting a public offering of shares. Shareholders in a public company can potentially sue in their own name under UK securities law to recover losses caused by false or misleading corporate disclosures. Under S459 of the Companies Act 1985, the risks posed to non-executive directors are negligible due to the fact that the UK lacks an analogue to SEC Rule 10b-5. Theoretically, any negligent misstatements in the annual accounts and other documents disseminated by UK directors can be the base for a suit by investors; however, this is only successful in rare events that the information provided to guide a specific purchase or sale of shares.

Directors of UK public companies can be held liable to shareholders for listing particulars that fail to include required material or that contain false or misleading disclosures. S90 of the Financial Services and Markets Act 2000 authorises a claim for compensation against persons responsible for preparing listing particulars. This claim is analogous to a U.S. claim under section 11 of the Securities Act of 1933 for a material misstatement in a prospectus. However, there have been no claims brought forward under S90 of the Financial Services Act 2000.

The FSA’s supervision and enforcement powers use individual responsibility and accountability as a core feature, with senior management responsibility a fundamental feature of the regulatory regime introduced by the Financial Services and Markets Act 2000 (FSMA 2000). Under the FSMA 2000, authorised firms must ensure that individuals who carry out so called “controlled functions” (certain key functions carried on in relation to regulatory activities specified in section 59 of the FSMA 2000) obtain approval from the FSA before performing such functions. After coming under much criticism following the onset of the financial crisis, the FSA is keen to assert an overtly strong regulatory approach.

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139 See GORE-BROWNE ON COMPANIES ¶ 43.27 (Alistair Alcock ed., 50th ed. 2004).
140 Brian R. Cheffins and Bernard S., Outside Director Liability Across Countries, 84 TEXAS LAW REVIEW, 1385, (2006).
Both the United States and the European Union have largely adopted disclosure as the underpinning model for securities regulation.\textsuperscript{142} The current regulatory approach to financial regulation has failed to deter harmful behavior that has resulted in unprecedented loss of value to shareholder as well as enormous liabilities to taxpayers. The current financial crisis is the most severe since the Great Depression.\textsuperscript{143} There has been no shortage of new ideas to reform the financial system, although current efforts have largely focuses on the symptoms of the excess such as executive pay and bonuses,\textsuperscript{144} calling for further disclosure and caps on incentive-based compensation. However, disclosure-based regulatory safeguards have failed to protect investors from the risks of actors in the financial industry seeking short-term gains at the expense of the public, and an ever-growing body of research points out the weaknesses of disclosure.\textsuperscript{145} Without a fundamentally different approach to regulation, the current disclosure-based regulatory model offers little hope of deterring the next major crisis.

The following discussion will examine the inherent weaknesses of the current disclosure-based financial regulatory system endorsed by the U.S. and European Union, and particularly the United Kingdom, and the challenges of transnational regulatory cooperation in financial regulation. The discussion will critically analyze the current culture of risk-taking in the financial sector which has had a detrimental impact on the public. Thereafter, this article will suggest alternatives for modifying behavior in lieu of additional disclosure-based rules as a means to deter excessively risky behaviour by financial institutions.

A. Weaknesses of Disclosure

A cornerstone assumption of regulatory models based on disclosure is the rationality of market participants. Accordingly, a mandatory disclosure scheme can work most effectively where investors, analysts, brokers, and other actors have access to enough information, are able to process the information sufficiently and behave in a rational manner.\textsuperscript{146} Much of the current reliance on disclosure-based financial regulation is

\textsuperscript{142} See Chiu, supra note 8.

\textsuperscript{143} In August 2009, the International Monetary Fund estimated the cost of the financial crisis to be approximately $11.9 trillion. \textit{See IMF puts total cost of crisis at £7.1 trillion, THE DAILY TELEGRAPH, 8 August 2009.} According to the news agency Reuters, market participants have estimated that 40-45\% world’s wealth have been destroyed in the crisis. \textit{See 45 percent of world’s wealth destroyed: Blackstone CEO, Reuters, March 10, 2009, available at http://www.reuters.com/article/idUSTRE52966Z20090311 (last visited October 2, 2010).}

\textsuperscript{144} The bonus system at large banks encourages individuals to seek short-term profits, which allows “members of the investment industry profit in good times but not share the losses in bad times and encourages unchecked risk taking.” See Aaron Unterman, \textit{Innovative Destruction—Structured Finance and Credit Market Reform in the Bubble Era, 5 HASTINGS BUS. L.J. 53, 86 (2009).}


Based on tacit acceptance of the efficient-market hypothesis,\(^1\) and assumes rationality in the financial markets and that “the independent judgments of buyers and sellers in a securities market will best determine accurate prices for securities if those buyers and sellers have adequate information.”\(^2\) However, the basic assumption of rationality may actually be flawed, which raises significant concerns with respect to investor protection.

Studies in behavioral finance have “documented aspects of “irrationality” in investors’ behavior and explored the implications of these deviations from rationality in the financial markets.”\(^3\) The notion that investors always operate rationally is refuted by research on cognitive constraints and biases\(^4\) as well as the cycle of the growth of bubbles in the financial markets.\(^5\) While a detailed discussion is beyond the scope of this article, research has shown that decision-makers routinely suffer from “information overload” and exhibit “herd behaviour” by following the actions of others rather than displaying a rational approach to decisions.\(^6\) Studies on rationality further suggest that decisions are the result of a host of factors and circumstances and investors are often confronted with more information than they can actually process.\(^7\) With too much information to digest and too little time to process it, “information overload can result in confusion, cognitive strain, and poorer decision-making.”\(^8\) Additionally, the impact of financial disclosure on investors can lead to “irrational exuberance and anxiety,” and “[i]t is well-recognized that investors can suffer cognitively from . . . being unable to cognitively process and understand too much information.”\(^9\) Therefore, “one of the most significant problems with relying on a disclosure-based system to protect securities market and investors is the flawed assumption that investors are purely rational actors who can utilize the disclosure effective to make optimal investment decisions.”\(^1\)

Whether as a result of complexity, fraud, or confusion, both analysts and investors routinely misjudge the actual value of securities. Studies by behavioral finance theorists have also demonstrated that the prices of securities are often mispriced.\(^2\)

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\(^1\) For a summary of the research on the efficient capital markets hypothesis, see Frederick C. Dunbar and Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 Del. J. Corp. L. 455, 462-465.


\(^6\) See generally Dalley, supra note 148, at 1114-1115 (reviewing and summarising research on the ability of individuals to correctly process information).


\(^8\) Ripken, supra note 32, at 160.


\(^1\) See generally Ripken, supra note 32, at147-148.

With respect to analysts, a growing body of research suggests that “hypermotivated” and “superoptistic” insiders in firms may act irrationally in underestimating risks by “emphasizing positive returns as indication of ability and downplaying trading losses as irrelevant.”\(^{158}\) Likewise, investors may exhibit “judgment biases that lead them to underestimate the risk that bad things will occur.”\(^{159}\) Further, the proliferation of information in the age of the Internet where many investors rely less on experts to filter complex financial information may result in investors actually suffering from the requirements of securities regimes based on disclosure.\(^ {160}\) As one expert notes, “More information alone cannot cure investors of the judgment biases that supposedly lead them to misuse the information.”\(^{161}\) Given all these contradictions to the assumptions of the efficient market theory, it is doubtful that disclosure in itself can adequately protect investors.

Further, a disclosure-based regime can allow market participants to conceal investment risks behind opaque complex financial instruments that neither “sophisticated” nor retail investors actually understand.\(^{162}\) Many experts blame the subprime mortgage crisis on the complexity in the financial markets along with a “lack of transparency” that caused even sophisticated investors to make poor investments, while “[f]inancial institutions overestimated their ability to disseminate values and comprehend risk.”\(^{163}\) The complexity of products in connection with the subprime mortgage industry illustrates the difficulty in reliance on disclosure as a means to regulate financial instruments, especially with respect to derivative instruments which are largely unregulated.\(^ {164}\) With respect to some collateral debt obligations (CDOs), for example, no amount of disclosure can adequately convey associated risks since investment banks “can tweak the inputs, assumptions, and underlying assets to produce a CDO that appears to add value, even though in reality it does not.”\(^ {165}\) Likewise, the corporate fraud crises of 2002 were in perpetuated by structuring transactions which complied with disclosure obligations while companies such as Enron and WorldCom “pursued a single-minded policy of boosting the company’s stock price at all costs.”\(^ {166}\) Accordingly, Enron was able to evade disclosure requirements with the help of “[u]niversal banks [which]... orchestrated a myriad of complex transactions” that enabled Enron to conceal approximately $25 billion in debt obligations.\(^ {167}\)

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other reasons that do not reflect economic fundamentals – have been shown to explain irrational changes in the price of securities. See generally Bradford Cornell and James C. Rutten, Market Efficiency, Crashes, and Securities Litigation, 81 TUL. L. REV. 443, 464 (2006-2007).

\(^{158}\) Ribstein, supra note 60, at 20.

\(^{159}\) Id. at 22.

\(^{160}\) Dailey, supra note 148, at 1089.

\(^{161}\) Ribstein, supra note 60, at 23.

\(^{162}\) The opaqueness of such financial instruments raises ethical issues with respect to the duty of financial institutions to market instruments which the creators of such instruments do not fully understand or judge to be sound investments.

\(^{163}\) See Unterman, supra note 123, at 72.


\(^{165}\) Id. at 1044.


\(^{167}\) Id. at 999.
Beyond the issue of complexity, financial institutions routinely exploit areas of regulatory lacunae as well as take advantage of exemptions from regulation. In particular, certain types of transactions such as those involving sophisticated investors and specific areas including derivatives and hedge funds are largely unregulated by either national or international rules. With respect to derivatives, in particular, the International Swaps and Derivative Association (ISDA) has actively resisted disclosure of credit swap documentation, insisting that the information is proprietary. Accordingly, market practices evolve with little or no guidance from financial regulators. While the Dodd-Frank Act in the United States grants authority to the CFTC and SEC to oversee the derivative industry, much of the key terms in the legislation is undefined. The subprime mortgage crisis that began in 2007 largely evolved from such a regulatory void, with financial institutions and other actors in the private sectors devising ever more exotic securitised instruments and off-balance sheet arrangements. To the extent that a regime of disclosure is incapable of offering adequate protection to investors, other measures to curtail unreasonably risky behavior by financial institutions could go a long way to protecting investors.

While disclosure regimes require companies and financial institutions to provide all pertinent information, the offeror of securities has significant discretion in determining whether it deems details material, and hence disclosed. Further, in the context of private placements which are effected pursuant to exemptions from disclosure requirements, it is unclear as to how the stakeholders in the purchasing entities are protected from overly risky investment decisions. Since many complex financial instruments are issued via private placements, a regime of disclosure will not adequately protect investors. Investors in residential mortgage-backed securities (RMBS), the instruments that played a key role in the subprime mortgage crisis, “had very limited opportunities to perform their own due diligence” and instead relied on the underwriters from which they purchased the RMBS, who “frequently cut costs and boosted profits by doing minimal due diligence of their own.” The justification is that investors in private placements meet certain tests relating to size and financial

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169 See generally Unterman, supra note 144.  
170 http://www.isda.org/ (last visited October 2, 2010).  
171 Parnoy & Skeel, supra note 164, at 1036.  
172 Indeed the U.S. Supreme Court has recognised that certain transactions involving sophisticated investors do not require the protection afforded by the federal securities laws as they are able to “fend for themselves.” SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).  
175 See generally Lola Miranda Hale, PRIVATE PLACEMENT OF SECURITIES (2004).  
176 The market for private placements is significant. In terms of equity offers alone, $162 billion was raised via Rule 144A equity offerings, which was more than the combined capital raised in IPOs on the New York Stock Exchange, Nasdaq and the American Stock Exchange in 2006. See William K Sjostrom, Jr., The Birth of Rule 144A Equity Offerings, 56 UCLA L. Rev., 409, 412 (2008-2009).  
177 Wilmarth, supra note 166, at 1026.  
178 Id.
sophistication. Yet, these investors manage the holdings of smaller and less sophisticated investors, the very individuals the securities laws were designed to protect. For example, ten times as much equity was raised in the private U.S. markets than in public market in 2005. In the context of derivates, not only is information on the instruments opaque, but the manner in which instruments are structured can make it difficult, if not impossible, to assess the associated risks.

Most regulators have detailed requirements for disclosure. In the U.S., the SEC specifies particular items in its various forms, and the EU Prospectus Directive contains similar corresponding disclosure requirements. Nonetheless, these requirements do not necessarily capture the dynamic processes and personalities that lead to decisions in the boardroom since “information a firm’s managers use to understand a company’s operations varies from manager to manager and from company to company.” Much of the information companies disclose in periodic reports and offering documents is only included if management deems it “material.” For example, decisions to include personal details under gap-filling and antifraud rules relating to noncorporate information are particularly sensitive, and “materiality determinations are perhaps the most tricky.” With respect to the EU in particular, the creation of a single market suffers from a lack of consistent set of rules to establish an efficient single market for securities. This diversity caused by the various national rules and regulations can lead to competitive distortions among the financial institutions and encourage regulatory arbitrage.

For the reasons discussed above, the current regulatory approach based on disclosure has proved to have significant defects in terms of protecting investors. The complexity of disclosure in public offerings raises questions as to whether any level of disclosure can adequately convey the risks of certain financial instruments, and it is doubtful that disclosure is even capable of conveying useful information in certain contexts. In his analysis of disclosure, Professor Steven Schwarcz has pointed out that certain transactions are so complicated that "few if any investors will actually

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180 See generally Partnoy & Skeel, supra note 164, at 1036.
183 See Greene et al., supra note 31, at § 3.03[1].
184 Hemingway, supra note 87, at 766. Hemingway points out that "executives must make these decisions in what may be highly stressful or emotionally charged situations (e.g., under threat of criminal prosecution or civil enforcement, in the wake of a medical diagnosis of a serious or terminal illness, at a time of financial strife, or during the course of a divorce or non-public marital affair) [. and] . . . decision making in times of stress, especially on matters involving a high level of sophistication and focus has a low possibility of being accurate, rational or optimal.” Id. at 767.
186 See generally Unterman, supra note 144.
understand the detailed disclosure.’’\textsuperscript{187} In fact, disclosure requirements can actually be counterproductive as they “may produce a wealth of complicated but ultimately unimportant information.”\textsuperscript{188} Both the regulatory systems of the U.S. and the European Union face severe challenges in protecting investors and the financial markets under the current disclosure-based systems.

B. Alternatives to Disclosure: International regulatory cooperation to deter overly risky behavior

Beyond the inherent flaws of disclosure, the interconnectedness of the financial system and the widespread impact gaps in national regulation can have throughout the global economy necessitate a new approach to discouraging risky behavior. The patchwork of national financial regulators that constitute the current “national approach to securities regulation” allow for “large gaps between domestic regimes which provide ample opportunity for firms to adopt marginal practices in pursuit of profits.”\textsuperscript{189} Additionally, efforts to implement reforms that focus on more substantive issues can become overly complicated and lead to increased costs without clear benefits.\textsuperscript{190} Given the inherent weaknesses of disclosure as well as the financial ingenuity that is usually one step ahead of regulators, other methods of influencing behavior are necessary to prevent overly risky behaviour that damages the public good. According to one expert, “it is also clear that far too many members of the industry behaved extremely recklessly and greater mechanisms of deterrence could have prevented at least some of the pain being felt now.”\textsuperscript{191} Investors as well can be misled during times of economic expansion and underestimate risks and place too much trust in the markets. “Since trust is a behavioural phenomenon, the behavioural biases that contribute to investor euphoria and the development of a bubble can lead to an excess of trust in the integrity of market participants.”\textsuperscript{192} Financial regulation inherently suffers from a free rider problem with an incentive to permit questionable practices as long as such tolerated by other regulators.\textsuperscript{193} Further, regulators are often reluctant to discourage banks from lending during asset bubbles since doing so could lead to a crisis.\textsuperscript{194} Likewise, government may also be reluctant to alert voters to assets

\textsuperscript{189} Unterman, supra note 144, at 109.
\textsuperscript{190} Many scholars have sharply critized the Sarbanes-Oxley Act for precisely these reasons. In his analysis of the legislative response to the corporate scandals of the early 2000s that led to the adoption of the Sarbanes-Oxley Act, Prof. Coffee notes, “The only effective antidotes to fraud are active and vigilant markets and professionals with strong incentives to investigate corporate managers and dig up corporate information.” See Ribstein, supra note 60, at 3. See also generally Naidu, supra note 20; John Gibeaut, \textit{Private Drive}, 91 A.B.A.J. 20 (2005); Cory L. Braddock, \textit{Penny Wise, Pound Foolish: Why Investors Would be Foolish to Pay a Penny or a Pound for the Protections Provided by Sarbanes-Oxley}, BYU L. REV. 175 (2006).
\textsuperscript{191} Unterman, supra note 144, at 80.
\textsuperscript{192} Gerding, supra note 151, at 421.
\textsuperscript{193} Professor Wilmarth has summarized the regulatory failures that led to the subprime mortgage crisis accurately and succinctly: “Over the past decade, regulators in developed nations encouraged the expansion of large financial conglomerates and failed to restrain their pursuit of short-term profits through increased leveraged and high-risk activities.” Wilmarth, supra note 166, at 1049.
\textsuperscript{194} \textsc{John Calverley}, \textit{Bubbles and How to Survive them} 167 (2004).
Bubbles actually trigger “political pressure to deregulate financial markets and dilute securities regulation. . . [which] manifests itself not only in efforts to roll back laws that would otherwise deter fraud, but also in under-enforcement of existing laws and resistance to proposals to address concerns about speculation or the growing risk of fraud.”\textsuperscript{196} For these reasons, it is all the more important that national regulators work together to avoid a free rider problem as well as de-politicize regulation which may stifle short-term “innovation” but protect long-term wealth.

In the context of the financial crisis precipitated by the subprime mortgage industry, each of the large banks are registered with the SEC and file periodic and annual reports. Yet, such disclosure failed to protect investors from a loss of $8 trillion on the U.S. equity markets alone.\textsuperscript{197} Rather than continue the cyclical pattern of lax regulation during periods of rapid economic growth followed by the adoption of a hodgepodge of new draconian national laws which might do little to deter future detrimental behaviour, the legislatures and securities regulators should agree to international standards of liability that will act to cure these market extremes. While such might appear overly ambitious, the alternative is to continue the ineffective, but politically expedient adoption of yet further regulations that are powerless to predict the next financial crisis. Financial regulators charged with ensuring efficient markets have been unable to provide regulatory supervision sufficient to prevent financial crises, and market participants are not deterred from the current liability regime. Indeed, many argue that penalties and liability are already too high. In U.S. law, Rule 10b-5 has become synonymous with harsh regulation. The U.S. SEC also has a “reputation as a ruthless enforcer with a ‘take no prisoners’ mentality.”\textsuperscript{198} However, others have pointed out that the SEC has not always been aggressive in prosecuting wrongdoing.\textsuperscript{199} For example, in the case of the Sarbanes-Oxley Act, the SEC is sometimes reluctant to impose penalties since any penalties assigned to a corporation “ultimately . . . are borne by shareholders.”\textsuperscript{200} Closer examination shows that criminal prosecutions under 10b-5 “consistently offer neither effectual retribution nor effective deterrence.”\textsuperscript{201} However, corporate fraud scandals continue in the United States and resulting damages are growing, even with current regulations in place.\textsuperscript{202} In addition, the European regulatory framework suffers from a lack of cohesiveness.

\begin{thebibliography}{2}
\bibitem{195} Id.
\bibitem{196} Gerding, \textit{supra} note 151, at 395.
\bibitem{198} Eugene F. Moloney, \textit{Banks and the SEC: A Regulatory Mismatch?}, 25 ANN. REV. BANKING & FIN. L. 442, 455 (2006). However, the SEC has often been regarded as less aggressive in pursuing possible violations.
\bibitem{200} Atkins and Bondi, \textit{supra} note 93 at 398. The authors describe Section 308’s Fair Fund distribution in the following manner: “The Fair Fund distribution thus creates a circular situation: The Commission penalizes a corporation to put the money into a fund to reimburse the shareholders who were themselves just indirectly penalized.” \textit{Id.} at footnote 171.
\bibitem{201} Joan MacLeod Heminway, \textit{Hell Hath No Fury Like an Investor Scorned: Retribution, Deterrence, Restoration, and the Criminalization of Securities Fraud under 10b-5}, 2 J. BUS. & TECH. L. 3, 7 (2007).
\end{thebibliography}
owing to the various culture, legislation, and practices among member states that lead to uneven enforcement of common directives.\(^\text{203}\) For example, the Transparency Directive only sets minimum standards which member states may enhance and thus create room for variations among member states with regard to ongoing disclosure obligation.\(^\text{204}\) In addition, where EC securities law harmonization leaves member states \textit{de jure} or \textit{de facto} no room for substantive variation in the design of national regulation, the fact that its private and public enforcement is almost purely a matter for the member states means that, in sum, differences in national securities law regimes are of significant relevance even with regard to the detailed prescriptions of EU directives. For example, in the United Kingdom, The FSA is guided by principle-based regulation\(^\text{205}\) that seeks, where possible, to avoid prescriptive rules which have not been able to prevent misconduct.\(^\text{206}\) However, the FSA has been criticised that its “light touch” principle-based regulation approach has been a primary catalyst for the failure of major UK banks and financial institutions as well as the collapse of the UK securitisation market since the summer of 2007.\(^\text{207}\) Only rigorous sanctions that are administered fairly and consistently can provide the deterrence necessary to discourage overly risky behavior.

Rather than vigorously enforcing sanctions, the SEC and other regulators have been lax in prosecuting violations. The past three decades have seen periods of economic bubbles accompanied by lax enforcement of regulation followed by aggressive steps by legislatures to adopt increased legislation.\(^\text{208}\) “This cycle of decay and re-growth is propelled by the dynamics of stock market bubbles and the epidemics of fraud they generate.”\(^\text{209}\) Moreover, recent financial crises have seen the rise of a “new breed of


\(^{204}\) See Luca Enriques and Matteo Gatti, \textit{Is There a Uniform EU Securities Law After the Financial Services Plan?} in Paul Krüger Andersen and Karsten Engsig Sørensen (eds), \textit{COMPANY LAW AND FINANCE} (Thomson, Copenhagen 2008) 167, 167-168. Additionally, the Takeover Bids Directive leaves the determination of the threshold percentage which activates the mandatory bid and its calculation to member states and allows defensive measures to both the restrictions for the target’s board deterring hostile bids and to the break through rule that suspends voting caps and transfer restrictions. See; Christian Kirchner and Richard W. Painter, “Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform,” 50 \textit{THE AMERICAN JOURNAL OF COMPARATIVE LAW} 3, (Summer 2002) 451, 460.


\(^{208}\) See Macey, \textit{supra} note 199, at 118.

\(^{209}\) Gerding, \textit{supra} note 151, at 394.
corporate executives who are unconstrained by the traditional devices of financial regulation. More worrying, at least in the context of the subprime crisis, governments have even tacitly endorsed and rewarded overly risky activities by bailing out financial institutions. One expert describes the dilemma in the following manner:

Allowing major institutions to profit from irresponsible financial dealings and then intervening when they get in over their heads makes it too easy for these firms to avoid the consequences of their actions. Morally, this action is reprehensible because it bails out the same people responsible for this crisis, inevitably with tax payer money, and has the effect of privatizing profit and socializing loss.\textsuperscript{211}

Against this background, the various national and international securities authorities and regulators should work to establish and enforce common standards of liability which clearly define overly risky behavior and then consistently enforce sanctions to provide an effective deterrent. In the absence of coordinated regulatory cooperation, jurisdictions which adopt harsher financial regulations risk driving financial goods and services to other jurisdictions. According to Professor Coffee, “disparities in enforcement may be able to explain what marginal differences in formal legal rules or disclosure standards cannot explain.”\textsuperscript{212} In so doing, “[t]hese cascade effects will add up very quickly, carrying with them the potential to set up alternative business regimes that are beyond regulation.”\textsuperscript{213} In addition, “the competition between regulators is not necessarily geared towards achieving regulation that is most optimal for the beneficiaries of the regulation”\textsuperscript{214} since the absence of common standards of liability exposes investors to greater risks depending on the effectiveness of local regulators. In a sense, “globalization of the markets results in less stable economies and increased risk for investors around the world” with volatility in one market increasingly affecting conditions in other markets.\textsuperscript{215}

The International Organization of Security Commissions (IOSCO)\textsuperscript{216} has led international efforts to harmonize the regulation of the capital markets,\textsuperscript{217} and could provide an impetus for national regulatory cooperation on establishing such a common approach. With over 170 members, including both governmental and

\textsuperscript{210} Larry E. Ribstein, supra note 60, at 9. Ribstein identifies such executives in the aftermath of the Enron scandal, noting that, “These executives are hyper-motivated survivors of a highly competitive tournament...who have proven their ability to make money while putting on a veneer of loyalty to the firm.” Ribstein also observes a willingness of such players to engage in risky transactions in a “corporate culture that instills loyalty to insiders and displays an “obsession with short-term stock price.” Id.

\textsuperscript{211} Unterman, supra note 144, at 81 (2009).

\textsuperscript{212} Coffee, supra note 179, at 242.


\textsuperscript{214} Chiu, supra note 8, at 765.


\textsuperscript{216} See generally http://www.iosco.org/ (last visited October 2, 2010).

private securities regulators, IOSCO has an informal structure and works to achieve "regulatory harmonization through consensus." IOSCO has formulated an array of principles and reports, largely through its Technical Committee. With regard to disclosure standards, IOSCO published its International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers in 1998 to encourage harmonization. The SEC adopted these standards in 1999, by revising its Form 20-F, the form which outlines foreign issuers’ disclosure and accounting requirements. Following these efforts to cooperate in the area of disclosure, IOSCO should focus its attention to establishing an international liability standard that which be an effective deterrent against future overly risky behavior in the financial markets. The introduction and enforcement of a common international standard for liability would help to limit the ability of company to engage in regulatory arbitrage. Likewise, such a common liability standard would enhance the scope of cooperation among national regulators in enforcing their respective securities regimes.

The current research concedes that defining particular behavior to be discouraged is necessarily difficult, and the legislature and financial regulators must work in concert to determine what standards to adopt. Under U.S. law, Section 24 of the Securities Act assigns criminal liability to “[a]ny person who wilfully violates” its provisions or rules and regulations adopted by the SEC thereunder. However, the precise definition of “wilfully” remains elusive, with both courts and legal experts grappling over various formulations. This regulatory lacunae necessarily leaves market participants open to develop practices without adequate guidance from regulators. It is therefore disingenuous of legislatures to create new laws in reaction to financial abuses without adequately providing standards that would have deterred such behaviour in the first place. Without a robust legal regime to discourage overly risky behavior that can harm the public good, disclosure alone will be ineffective. Without vigorous enforcement, these penalties lack a deterrent effect as one expert eloquently points out:

The politicians appear to rely on the notion that potential offenders will be deterred from engaging in wrongdoing they will fear longer terms of incarceration. This rationale relies on the faulty assumption: that these

219 Id. at 565.
220 Id. at 564.
223 See Zaring, supra note 218, at 567.
224 See Greene, supra note 31, at 2-21.
226 See generally Michael L. Seigel, Bringing Coherence to Means Rea Analysis for Securities-Related offenses, 2006 WIS. L. REV. 1563 (2006). Professor Seigel summarises various explanations of the meaning of “wilfully,” (Id. at 1584-1590) finally noting that the leading commentator on U.S. securities law Louis Loss had “also failed to adequately address the interpretation of the word ‘wilfully’ in his seminal work on securities regulation.” Id. at 1590.
227 See generally J. Robert Brown, Jr., Corporate Governance, the Securities and Exchange Commission, and the Limits of Disclosure, 57 CATHOLIC U. L. REV. 45 (2007-2008). According to Professor Brown, “In the absence of strong underlying legal obligations, the use of disclosure as a tool to regulate substantive behavior is far less effective.” Id. at 79.
lengthy terms of imprisonment and high fines actually will be meted out. Numerous variables play a role in determining the actual sentence imposed by the courts . . . which enables greater judicial discretion in sentencing offenders.\textsuperscript{228}

In response to the financial crisis, the FSA has taken a more aggressive approach, pledging to engage in enforcement actions as a “credible deterrence” tool against rogue firms or individuals.\textsuperscript{229} These aggressive actions by the FSA and the SEC in the wake of the financial crisis go a long way to restoring investor confidence in the market. However, these steps in the U.S. and UK fall short of a concerted approach to liability in the international regulation of securities. As has been argued above, only such a unified, consistent approach to liability and enforcement will deter future crises.

Conclusion

As investors have unprecedented access to opportunities around the globe, financial crises which begin in a particular sector or market have the potential to spill over into other sectors and markets. The global repercussions of the U.S. subprime mortgage crisis illustrate the interdependence of the modern international financial system and the speed with which localized problems can spread.

The history of financial regulation has been punctuated by regulators chasing after ever more innovative bankers and the products which earn their bonuses. “The only effective antidotes to fraud are active and vigilant markets and professionals with strong incentives to investigate corporate managers and dig up corporate information.”\textsuperscript{230} While sunlight continues to be the best disinfectant, securities regulation systems based on disclosure could be substantially strengthened by adopting—and consistently enforcing in times of both boom and bust—stricter liability for fraudulent and overly risky investment activities, which could help to disincentivize reckless behavior.

\textsuperscript{230} See Ribstein, supra note 60, at 3.