

## **The Interaction of Formal and Informal Mechanisms in Shared Regulation**

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Public affairs scholars have written extensively about managing across sectors. They note that public, private, and nonprofit organizations complement each other, each should play important roles within in public policy, and open legal and political systems require such involvement even if an organization wanted to resist it. Research on public management should identify the conditions under which such relationships operate more or less successfully. We normally analyze these issues at the organizational level or higher because the underlying question is how an interorganizational system operates (Agranoff & McGuire, 2003; Bardach, 1998; Cook, Hardin, & Levi, 2005; Goldsmith & Eggers, 2004; Kettl, 2002; Lynn, 2006; Milward & Provan, 2003, 2006).

Public affairs scholars also have written extensively about how employees factor external political, legal, or economic conditions into their work (Simon, 1997). As Diane Vaughan notes in discussing the topic of misconduct in organizations generally,

Explanations incorporating the influence of the competitive environment, for example, tend to express that influence using concepts like “pressure,” “stress,” or “strain” upon the organization without linking it to the actions of individual organization members. As Donald Cressey wrote in response to the leaps of faith in my own (1983) research, “As long as we glibly attribute behavior to ‘pressures’ and ‘strains,’ we will continue to be ignorant about what is going on”....The link between individual choice and the structural determinants of those choices is paramount to understanding misconduct both in and by organizations (Vaughan, 1992).

We study how individuals respond to interorganizational relationships in the course of their jobs mainly at the individual or group level at which the work occurs (Khademian, 2002b; Maynard-Moody & Musheno, 2003; Riccucci, 2005; Schön, 1983; Wilson, 1989). Writings on work within organizations focus less on interorganizational relationships because the levels of analysis are different.

If interorganizational relationships across sectors and the nature of work within organizations both are important, then research connecting them would help us understand how

programs get implemented and are managed more or less effectively. This article examines the issue using regulatory behavior as a case in point: how economic, legal, and technological forces structure the context in which regulated firms and regulatory organizations operate and accordingly shape activities within those organizations.

Business regulation exemplifies the themes that public, private, and nonprofit organizations have different comparative advantages and responsibilities and that relationships across sectors substantially determine the effectiveness of public management and policy. The basic regulatory tradeoff is between the benefits of giving firms discretion over production and the benefits of outside controls on production's excesses. A firm's insiders understand locally efficient production more than outsiders because they work with the firm's technology constantly and have incentives to improve it. They want operational discretion in order to expedite work, facilitate innovation, and attract customers, and society loses the benefit of insiders' knowledge if outsiders intervene routinely to tell them how to operate. However, insiders' single-minded focus on production can lead them to slight other considerations like environmental or employee safety, full disclosure in advertising, or fiduciary responsibilities. Markets prevent such harmful conduct unevenly and consequently society often suffers. Society, through government regulation and other legal controls, induces firms to pay attention to such considerations more than they would otherwise.

But, as Charles Lindblom somewhat overstated, authority systems operate "with strong thumbs and no fingers" (Lindblom, 1977: 65). Governments cannot understand the industry's processes as well as insiders, and regulatory procedures mitigate this problem only partially; controlling complex interactions in corporations through legal commands, while commonly necessary, is extraordinarily difficult. Furthermore, just as firms may slight important values,

regulatory agencies may focus so much on preventing problems that they extend controls beyond the point where the controls' costs relate reasonably to their benefits. Industry argues, self-interestedly but often plausibly, that technological changes will make rules obsolete or that fixed rules will stifle technological development. Experienced practitioners and scholars of regulation have observed for over a century that regulators' challenge is to oversee industry as guided by laws without imposing rules that inhibit excessively productive work and innovation (Bardach & Kagan, 1982; McCraw, 1984).

Centralized design and enforcement of rules remains an important part of regulation, but newer approaches try to manage more effectively the tradeoffs of regulatory control and firms' operational discretion (Ayres & Braithwaite, 1992). Especially effective inspectors always have enforced rules credibly while crediting firms for good faith efforts to comply, and the combined approaches alter firms' behaviors more than either approach taken alone (Bardach & Kagan, 1982; Potoski & Prakash, 2004; Scholz, 1991; Sparrow, 2000). Such enforcement discretion often is formalized; agencies allow firms to develop internal controls tuned to their own systems but hold firms accountable for supervisory failures if the controls break down. This accepts that firms are in the best position to oversee their own operations while recognizing how internal controls erode without effective external oversight (Bennear, 2007; Coglianese & Nash, 2006; Michael, 1995; Rees, 1994, 1997).

It is difficult to study the details of how firms implement regulations and their routine dealings with regulators. Surveyed firms are willing to comment about their attitudes toward regulation in general but usually do not welcome research on their decision making and internal regulatory politics. Thus, studies of compliance such as those made of the pulp and paper industry, drug and mining industries, nuclear power, and homebuilding and marine operations

are valuable but unusual (Braithwaite, 1984, 1985; Gray & Scholz, 1993; Kagan, Thornton, & Gunningham, 2003; LaPorte & Thomas, 1995; Marcus, 1988; Marcus & Majumdar, 2001; May, 2005; May & Wood, 2003; Rees, 1994). These studies suggest that understanding regulatory implementation within firms requires looking at how external pressures interact with an organization's culture and managerial choices—essentially, the general issue, identified at the outset of this article, of connecting the environment to an organization's work. That is the process studied here. We focus on regulation of the United States securities industry although discuss later how the findings apply more generally.

### **INSTITUTIONS EXAMINED AND METHODS**

Federal securities laws establish a three-tiered system of regulation (Coffee & Seligman, 2003). The Securities and Exchange Commission (SEC) is the key national regulator of the securities industry, although agencies such as the Commodity Futures Trading Commission, the Federal Reserve, and state agencies also regulate financial firms. The SEC relies heavily on self-regulatory organizations (SROs) for routine regulatory oversight and enforcement. Prior to mid-2007 the two most important securities self-regulatory organizations were the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE); in July 2007 the NASD merged with the largest part of the NYSE's regulatory operations to form the Financial Industry Regulatory Authority (FINRA). To put the SEC's reliance on SROs in perspective, in federal fiscal year 2006 the SEC initiated 75 enforcement cases involving securities firms or related individuals out of its total of 574 cases of all types, including cases targeting corporations issuing securities and investors (United States Securities and Exchange Commission, 2007). In comparison, in calendar year 2006 the NASD resolved 1,147 formal disciplinary cases involving securities firms and related individuals (Financial Industry

Regulatory Authority, 2007b) and our data indicate that the NYSE concluded 229 such cases. A survey of securities firms reported that 85.1% of their regulatory inquiries over the preceding 12 months came from the SEC, NASD, or NYSE, with 7.2% from states (Securities Industry Association, 2006: 13).

These regulators, and other smaller self-regulatory organizations overseeing their own markets, oversee securities firms ranging from Citigroup, Merrill Lynch, Goldman Sachs, and Morgan Stanley to firms with only a few employees. Regulators rely on the firms' supervisory systems to prevent securities law violations on the grounds that the firms are in the best position to oversee their own operations. They may fine firms, or worse, if firms' internal regulatory systems fail in some important way.

Other types of controls fundamentally affect the SEC, SROs, and firms. First, market participants can stop dealing with firms they do not trust or withdraw from the market entirely, hurting firms economically and giving them an incentive to improve their controls; visible market failures also increase pressures on the regulators charged with overseeing markets. Second, private civil litigation and arbitration damage firms in which violations occur and alert regulators to problems. A third group of institutions—Congress, state officials, and the press—intervene unevenly but influentially in securities regulation.

This article discusses the relationships among these external controls, regulatory controls, controls within firms, and the general implications for public management and policy. To examine these issues this article uses a data base of all formal NYSE disciplinary actions from 1990 through 2006, interviews, observation at meetings of regulators and firms, and public material.

### **NYSE Disciplinary Proceedings**

The New York Stock Exchange reports minutes of its disciplinary proceedings on its website (<http://www.nyse.com/DiscAxn/discAxnIndex.html>). We coded the minutes of all the cases from 1990 through 2006 (3,301 cases), noting the firm and individuals involved, up to five violations, penalties, time period of the violation, how the violation was brought to the NYSE, and other aspects of the case. The NYSE's cases are not representative of all SRO cases. Prior to FINRA's formation in 2007 through merger of the NASD with much of the NYSE's regulatory operations, the NASD handled more cases because virtually all securities firms belonged to the NASD, including the many smaller firms which are not NYSE members. Fundamental relationships between NYSE and NASD regulators and those they regulate are similar, however, and the NYSE's case descriptions are more detailed than the NASD's brief summaries. While the NYSE's cases from 1990 through 2006 are not representative of all SRO cases, they indicate regulatory patterns in useful ways.

### **Interviews**

Between November 2003 and July 2007 we interviewed 34 individuals involved directly in or overseeing this regulatory system, with most of the interviews at the executive or senior-staff levels and lasting between one and two hours. These included three from the SEC, nine from the main SROs, ten individuals in senior legal and compliance positions in securities firms, two outside attorneys advising firms, two state regulatory officials from different states, three individuals with relevant Congressional committees, and five with the Government Accountability Office in a group interview. The interviews focused on the individuals' assessment of the centrality of organizations involved in securities regulation, their working relationships with the other parts of the system, their work within their own organizations, and

current regulatory issues. We asked permission to take notes during the interviews and permission always was granted. The quotations used here were produced from those notes.

### **Observation at Conferences on Securities Regulation**

The article draws on observation of panels involving regulators, legal and compliance professionals within firms, and private attorneys at eight conferences on securities regulation between November 2003 and March 2007. Five of these were sponsored by the Compliance and Legal Division (CLD) of the Securities Industry Association (SIA); the SIA merged in 2006 with the Bond Market Association to form the Securities Industry and Financial Market Association (SIFMA). CLD-SIFMA is the main private national organization of individuals involved in securities regulation. The conferences included a one day seminar on legal and compliance issues sponsored by the CLD and the CLD's three-day national conferences 2004 through 2007, the three-day national conference of the North American Securities Administrators Association (NASAA)—an association mainly of state securities regulators—in October 2004, and two-day regulatory conferences organized by the New York Stock Exchange in June 2005 and 2006. About 300 participants attended the single day seminar, and well over 1,000 participants attended each of the other conferences; for example, about 1,800 participants attended the national conferences of the Compliance and Legal Division. The quotations used here were produced from notes taken during the sessions.

These conferences were especially valuable to this research. Virtually all of the registrants listed in the conference programs were industry and regulatory professionals. The conferences consisted of plenary sessions and smaller panels usually with five or six participants who were senior legal and compliance staff within securities firms, outside attorneys advising firms, senior staff of the SEC, NYSE, NASD, and/or state regulators, and individuals from

Congressional committees. Sessions focused on issues facing regulators and firms, what regulators expected of firms, and how firms dealt with these expectations. The conferences complemented the interviews because they involved a large number of professional participants engaging each other directly, a context different from interviews with academic outsiders.

The article also draws on Congressional hearings, public and private reports, the industry press, and other material related to the securities industry and its regulation. The data on disciplinary proceedings, interviews, conference proceedings, and written material collectively provide a reasonable understanding of how environmental factors and work within firms and regulatory organizations influence each other. The next section describes core regulatory issues within securities firms. We then discuss how environmental factors affect how regulatory organizations and firms handle these issues, and finally the broader implications of the article.

## **THE NATURE OF REGULATORY PROBLEMS IN THE SECURITIES INDUSTRY**

Securities markets allocate funds among investors, firms, and other participants with different preferences so that, ideally, participants use the funds most efficiently to produce goods and services, manage financial risks, or invest. Transactions in these markets usually are risky and the securities laws' fundamental purpose is give participants' enough confidence to enter them. Participants have to be willing to exchange for assets that commonly are intangible or unobservable (like distant businesses), subject to loss, and usually not insured. Furthermore, most of the time participants do not understand the transactions fully or otherwise are dependent on the integrity of those with whom they are dealing; they use securities firms as intermediaries because the firms have knowledge, access, and abilities that they lack (WirthlinWorldwide, 2004). Securities laws require participants to disclose information and require certain business

practices to reduce the chances that participants will default on transactions, cheat others, or otherwise undercut the confidence on which the markets rest (Coffee & Seligman, 2003: 2-7).

More than any other factor, competition for revenues drives behavior in securities firms because revenues from transactions produce credibility which in turn attracts more transactions and more revenues, producing more profit. Competition among firms for rankings in “league tables” for business areas is strong and an individual’s ability to draw revenues to the firm is the industry’s most highly valued skill (Berman, 2007b; Eccles & Crane, 1988; Kuznetsov, 2007; R. C. Smith & Walter, 2006). Securities firms compensate, promote, and demote brokers, traders, and investment bankers (their “producers” or “business people”) mainly based on the revenues they bring into the firm through sales, trading, investment banking, and product innovations. An article on securities industry pay in *Investment Dealers’ Digest* in 2007 commented that “Top producers within investment banking generally saw their total compensation rise 20% and at times more...But pay increases vary widely among bankers, with some receiving a smaller or higher increase. ‘Pay is now a meritocracy,’ says Sterling’s [Laura] Lofaro. ‘The increase in 2006 over 2005 was 15% to 20%,’ she says. ‘If you are a business developer and produced a lot of revenue, your compensation would be higher than that. But if you are an execution person you are not going to be up like that’” (Louria, 2007: 16).

Rules requiring information disclosure, recordkeeping, and other conduct inevitably slow or inhibit transactions and so producers usually live uneasily with them. Kuznetsov conveys the image of such rules: “Compliance officers...oversee the operations of existing business lines and play an important restraining role in the development of any new business processes (as one of my trader colleagues used to tell me, compliance’s job was to say that anything I wanted to try was not a good idea)” (Kuznetsov, 2007: 37; Langley, 2007). This does not mean that producers

will violate rules routinely; in fact, most of the time producers comply with rules enough to avoid regulatory trouble and/or unresolved customer complaints, even if this slows transactions. Undoubtedly there are many violations that do not rise to the level of formal actions or that customers miss entirely, but analyses by public and private regulators suggest that disciplinary actions, arbitrations, or customer complaints target less than 1 percent of securities brokers and traders in a given year (National Association of Securities Dealers, 2003; United States Securities and Exchange Commission, 1994, 2003). A very small share of business would produce regulatory problems even if that were a serious underestimate.

But financial market activity is so extensive that a small rate of violations will produce a large number of problems. Furthermore, legal problems do not require unethical, corrupt individuals to have violated rules in systematic and premeditated ways. While some people are “chronic offenders” and “seekers” of opportunities for white-collar crime, rule violations usually occur through subtler processes (Weisburd, Waring, & Chayet, 2001). People may see profitable conduct as being in a “gray area” of being neither clearly legal nor illegal, proceed as if it was legal, and find regulators, courts, or arbitration panels disagreeing with them. Or, they regard the behavior as only “technically” illegal, saying that “everyone does it” and, like someone driving 70 in a 65-mph zone, conclude that the chances of enforcement are almost nonexistent. Or, individuals trying to scramble out of a desperate situation—like huge losses hidden from supervisors or their brokerage customers—see deception as the only way to recover and thus worth the risk of detection.

To support the idea that “good compliance is good business” one can cite examples of firms suffering devastating legal and economic problems after insiders exploited customers or otherwise violated rules. But that is reasoning in hindsight. Probably more typical are cases in

which insiders operated “close to the edge” because of what they saw as competitive realities, and in which they avoided regulatory problems and benefited economically. Also, individuals’ incentives frequently differ from the firm’s incentives. An attorney with extensive experience in public and private regulatory operations wrote in 2007 that

The cost analysis [of noncompliance] is further complicated by the contingent nature of liability, i.e., a particular problem may never be discovered by the regulators and therefore actual costs may never be incurred. Even if a problem is discovered, it may not result in actual costs to the firm for a number of years, by which time the P&L [Profit & Loss] has already been booked and employee bonuses paid. Responsible employees may have left the firm or moved to different positions, never knowing the negative impact of the problems they left behind. And, past success tends to remove the urgency and undercut concern about future risks. Complacency leads to under resourcing of critical support functions. The fact that many firms have avoided large regulatory penalties in the past does not necessarily mean that the current level of resources dedicated to supervision and compliance is sufficient (Berman, 2007a; Citera, 2007: 3)

So, incentives to follow best practices in regulatory management or to forego profitable “gray area” transactions because of a low risk of future regulatory problems are weaker than incentives for immediate production and profit. This varies by job, of course; internal legal and compliance staff differ from producers. One General Counsel in a securities firm noted that “Sometimes there’s just a difference of opinion. In the case of disciplining a strong producer, a manager might say that the facts in a pending case are not entirely clear. The compliance person might come down the other way. It’s a matter of judgment. Production people might want to take more risks; compliance people might be more risk averse” (McCaffrey & Hart, 1998: 153).

However, business units are more influential within the firm because they bring in the revenues on which the firm clearly depends in both the short and long run. Business units are compensated more than legal and regulatory compliance units; in 2005 the weighted average compensation for the “Sales and Trading/Financial Management” area of securities firms was about \$128,000 compared to about \$70,000 for the “Compliance, Audit, Examiners and

Lawyers” area (Securities Industry and Financial Markets Association, 2007: 31). It is taken for granted that business units will guide the firm’s major decisions and revenue-generating routines. In contrast, legal and compliance professionals constantly discuss the extent to which they are or are not included in the routines of decisions regarding business issues, how their reporting relationships convey more or less organizational power, and how much their organizational influence in any period depends on external pressures on the firm. Individuals from industry regularly state variations on this comment made at the 2006 Compliance and Legal Division conference: “We spend too much time on structure. The key issue is stature. Is compliance at the right meetings? How is it viewed by business units? We spend entire panels on structure, but what we’re really talking about is stature. Are you there when business issues are discussed? Stature is far more important than structure.”

Factors increasing regulatory compliance must potentially affect a firm’s profit and/or the careers of individuals involved in the business units. They must operate sufficiently independently of the business units, although business unit support or at least acceptance probably strengthens their influence. They must induce upper management to shift the firm’s politics somewhat in favor of those favoring tighter controls. The next sections discuss a series of such factors: market controls, private litigation, intermittent investigations by Congress, state enforcement officials and the press, and regulatory pressures. These all operate unevenly, but also complement each other.

### **MARKET CONTROLS: INSTITUTIONAL AND INDIVIDUAL INVESTORS**

Market failure justifies regulation and so effective market controls obviously reduce the need for it. When markets work well, participants know and follow the rules governing

transactions. All participants understand the products involved, run their operations effectively, and have incentives not to cheat others because otherwise the ensuing failures harm them.

Enough buyers and sellers participate so that those deceiving others or mismanaging operations are shunned in favor of those with whom it is easier to deal. Market controls operate differently in securities transactions involving institutional versus individual (“retail”) investors.

### **Institutional Markets**

In the 1930s the Federal government wrote the main securities laws to protect individual investors, who at the time owned the majority of securities, because they saw individual investors as especially vulnerable to deception. Securities markets have evolved to the point where institutional investors like mutual funds, pension funds, insurance companies, hedge funds, and corporations now account for far more regulated activity than individuals. In 2005 about 57 million United States households and 91 million individuals owned equities, but they tended to own them through institutions rather than directly. Fifty-one percent of equity investors owned only stock mutual funds, 10% only owned equities directly, and 39% owned both, and the trend is toward ownership through institutions (Investment Company Institute & Securities Industry Association, 2005: 10-12).

Institutional investors—often referred to as “counterparties” in transactions, “the buy side” as opposed to the “sell side” of securities firms, or “end-users” of complex products—vary in their economic power and skills but as a rule deal with securities firms more effectively than individual investors. Institutions are more knowledgeable and can retaliate more effectively if cheated or otherwise harmed by securities firms. Larger securities firms depend on institutional investors for the majority of their revenue-generating activities and so have to maintain good working relationships with them. Institutional investors and firms usually both depend on

transactions going smoothly and so some governmental pressure, short of direct regulation, regularly is enough to get securities firms to address related regulatory problems. For example, large financial firms have worked collaboratively with regulators to remedy operational problems threatening the reliability of markets in complex financial instruments marketed almost entirely to institutions (Counterparty Risk Management Policy Group II, 2005; Faerman, McCaffrey, & Van Slyke, 2001; United States Government Accountability Office, 2007a).

Institutional investors thus depend less than “retail” investors on regulation for protection. Former Federal Reserve Chairman Alan Greenspan suggested in Congressional hearings in 2000 that “We regulators cannot conceivably substitute for the effectiveness of containing risk that counterparty judgments within the market create. It is not even a close call. Anything that we can do to sustain and enhance the viability of counterparty surveillance and the accordingly important strengthening of the financial structure that ensues as a consequence of that, we should endeavor to do” (United States Senate Committee on Agriculture Nutrition and Forestry & United States Senate Committee on Banking Housing and Urban Affairs, 2000: 16). The law accordingly treats transactions between institutional investors and securities firms differently than those involving individual investors. On the notion that they can take care of themselves, “accredited investors”—usually institutions—legally can enter transactions such as investment in hedge funds unavailable to most individuals (Coffee & Seligman, 2003; Scannell, 2007).

However, even though market controls work more effectively in institutional than in retail markets, regulation and litigation remain important because they govern negotiations and intervene when disputes cannot be settled privately. Also, regulatory agencies frequently accuse securities firms and related employees of violating laws in their dealings with institutional

investors; these cases have involved fraud against public or private institutions, collusion among securities firms and privileged institutional customers in mutual fund transactions, and illegal sharing of inside information with hedge funds, among others. Regulators, congressional committees, and the press usually identify individual investors as the ultimate victims in such cases either because the participating institutions managed individuals' money or profits came at the expense of individuals with no access to privileged arrangements (Frankel & Cunningham, 2006; Partnoy, 2001; United States House of Representatives Committee on Financial Services, 2003a; United States Senate Committee on the Judiciary, 2007). So, market controls in institutional markets lighten the load on regulation and litigation but do not supplant them.

### **“Retail” Markets**

Securities firms have reduced the services they extend to individual accounts because individual investors are less important than institutions or very wealthy investors to their revenue streams (Schack, 2007). A Securities Industry and Financial Markets Association (SIFMA) report on revenues through 2006 noted that “Commission and fee income, long a core business line of traditional brokerage activity, has been steadily declining in relative importance to the industry as a whole for the last quarter of a century, as changes in order handling rules and technological revolution led to sharpened competition and a steady long-term reduction in average revenues, expenses and profit margins as this business line became increasingly ‘commoditized’” (Securities Industry and Financial Markets Association, 2007: 8). SIFMA noted that commissions and fees constituted about 22% of revenues in 2006 (down from 26.2% 2001-2005), larger securities firms depended less on commissions than smaller firms, and most commission and fee revenues for larger firms came from institutional rather than individual accounts (p. 8).

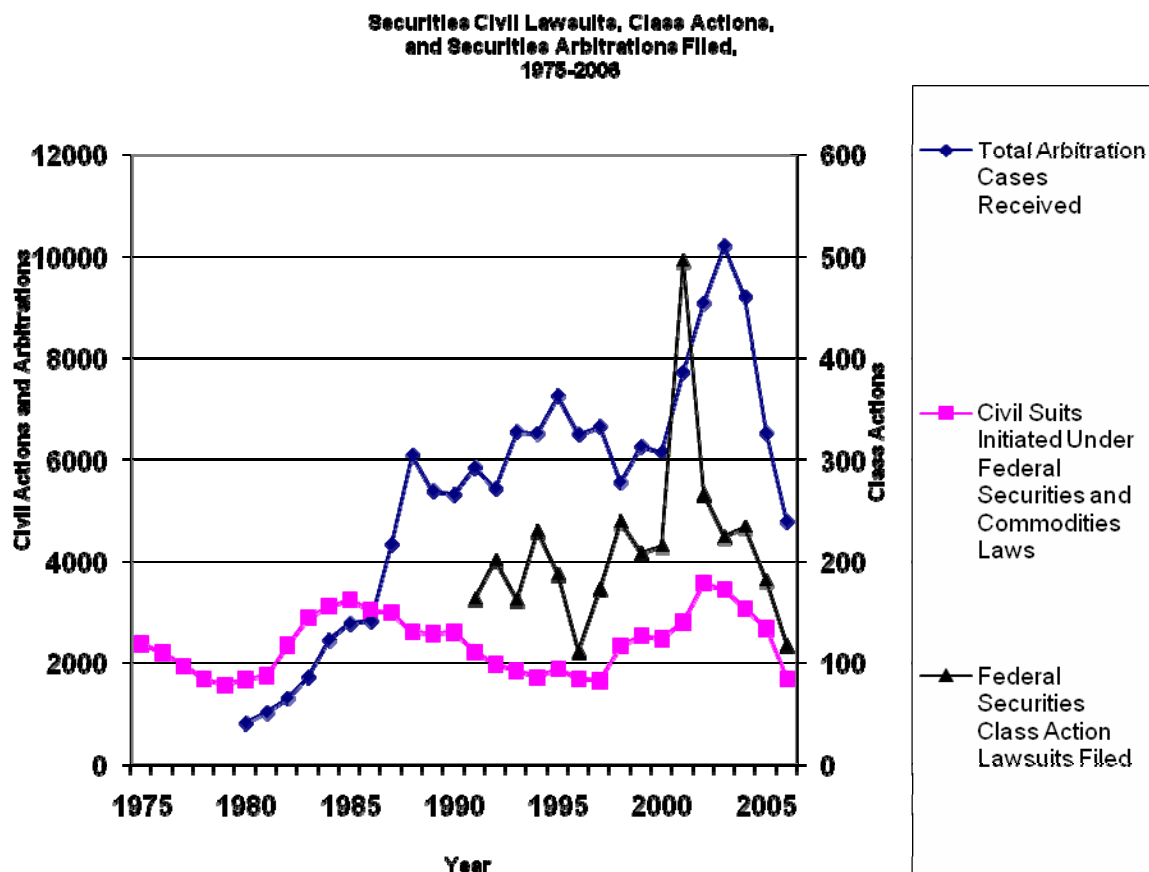
Although individual investors are less important economically than they once were, they can create problems for regulators and the securities industry if in large numbers they stop investing because of regulatory failures. Also, “protecting the small investor” is a politically powerful theme of the regulatory and legal system (Levitt, 2002), and individuals’ complaints prompt many regulatory actions. We coded 3,301 NYSE disciplinary actions from 1990-2006; 1,237 directly involved customer relationships, such as misappropriating funds from a customer, unauthorized trading, or excessive or unsuitable trading for a customer. The record referred explicitly to a customer complaint or inquiry notifying the firm of the problem in 809 of these 1,160 cases (65%), and in many other cases we suspect that the text simply did not report that the firm had learned of the problem through a customer complaint. Individuals also generate most of the arbitration cases, discussed below.

### **PRIVATE LITIGATION AND ARBITRATION**

Investors can sue businesses in court when they claim that they have suffered losses because of fraud or other wrongful action. In most cases involving securities firms, however, individual investors sign contracts requiring them to submit disputes to arbitration, in the past with the NASD or NYSE and, now, the Financial Industry Regulatory Authority. Figure 1 indicates the number of civil suits filed with United States District Courts under Federal securities and commodities laws, 1975 through 2006, and the number of class action lawsuits filed under the laws from 1991 through 2006. These lawsuits usually target corporations offering securities, but frequently name securities firms as well because of their underwriting or advisory operations; the extent to which investors can sue securities firms as advisors is subject to a continuing legal debate (Cornerstone Research, 2007; Turan et al., 2007). The figure also

reports the number of arbitrations initiated with the stock exchanges and the National Association of Securities Dealers from 1980 through 2006.

An upward trend in securities cases in the early 1980s reversed in the mid-1980s and arbitrations increased when most lawsuits involving broker-dealer disputes with customers were diverted to arbitration after the Supreme Court declared in *Shearson/American Express, Inc. v. McMahon* (482 U.S. 220) that pre-dispute arbitration agreements between firms and customers were enforceable. New arbitrations and lawsuits increased substantially following the market losses in 2000-2002, but then declined as the markets recovered. (The spike in class action civil suits in 2001 reflected 312 cases involving initial public offerings [IPOs]). Economic trends in financial markets, uneven corporate attention to preventing fraud, and shifting legal requirements for filing and winning lawsuits jointly produce fluctuations in private litigation and arbitration; analysts differ in their explanations of how they interact (Cornerstone Research, 2007).



Note: Individual civil suits and arbitrations read off of left axis, and class action suits read off of right axis.

Sources: Consolidated data on securities industry arbitrations received for calendar years 1980 through 2004 obtained from Securities Industry Conference on Arbitration *Thirteenth Report* (Securities Industry Conference on Arbitration, 2005). The 2005-2006 arbitration data include only the NASD and NYSE because a consolidated report was not yet released, but, for example, the NASD and NYSE accounted for all but 23 of 9,225 cases in 2004. Data on civil suits initiated under Federal Securities and Commodities Laws for 1975-2006 obtained from United States Administrative Office of United States Courts for various years. The reference years used in the statistical reports of the Administrative Office varied over time and so the data across years are not strictly comparable. Total civil case data cover from 1975-1994 cover July 1 through June 30 of reference year; civil case data from 1995-1999 cover October 1 through September 1 of reference year; and for 2000-2006 cover April 1 through March 31 of reference year. Data on class action suits obtained from Stanford University Securities Class Action Clearinghouse at <http://securities.stanford.edu>.

Lawsuits and arbitrations consume substantial time and resources and potentially damage severely the targeted firms and individuals. Once a case gets into the legal and arbitration

system the firm loses a good deal of control over outcomes decided by a judge, jury, or arbitration panel, and higher litigation and arbitration risks increase firms' attention to regulatory controls. Thus, six panel sessions at the 2007 meetings of the SIFMA Compliance and Legal Division were devoted specifically to arbitration and litigation, and in all of the conferences observed for this research panelists referred constantly to how the costs of civil litigation and arbitration justified stronger internal controls.

### **INTERMITTENT BUT INFLUENTIAL INTERVENTIONS: CONGRESS, STATES' ENFORCEMENT, AND THE PRESS**

The interviews and conference proceedings highlighted three other forces that operate more irregularly than market controls, private litigation, or regulation. These are Congress, the press, and attorneys general and other forms of securities regulation within states.

Congress can pass laws fundamentally altering securities regulation, oversees the SEC, and its hearings and reports can turn issues into crises for the firms and regulators involved. One panel at the 2007 Compliance and Legal Division conference discussed the possibilities of moving to a system relying less on enforcement and more on cooperative resolution of issues among national regulators and firms (a "prudential oversight" approach). An attorney with extensive experience in the public and private sectors commented that "I would not underestimate how difficult politically it will be to achieve a system of prudential oversight. Ultimately Congress and the press will want to see regulators racking heads....I am pessimistic that regulators will see enforcement as something to be used sparingly, which is a change in attitude required for prudential supervision to operate." Another added that "Congress wants enforcement actions to hold hearings about."

Also, constant themes in the interviews and conferences were the “*Wall Street Journal*” test—that an individual should screen a decision partly on the basis of how it would look if reported in the *Journal* or *New York Times*—and how the press provokes investigations and regularly damages reputations, and how managing relationships with the press is an important part of regulatory strategy. Finally, participants see an ongoing threat of politically entrepreneurial state officials filing enforcement actions independently of the SEC and national SROs, with the state officials responding that national regulators frequently act insufficiently aggressively. New York State Attorney General Eliot Spitzer’s interventions in several issues in 2002 and beyond exemplified such cases, but there are others as well (McCaffrey, Smith, & Martinez-Moyano, 2007). Discussing efforts among regulators to coordinate their activities under a system of “consolidated supervision,” the two attorneys remarked “Do you think Eliot Spitzer would have cared about consolidated supervision? Or that Andrew Cuomo [his successor] will?,” and “I’m pessimistic that state AGs [attorneys general] will become less aggressive now that they’re interested in securities regulation.” Similar quotations could be produced from the interviews and conferences almost at will.

In practice, however, Congressional, media, and state enforcement pressures are influential but intermittent. Congress influences the SEC more than any other single organization, but does not focus on individual firms in the absence of conspicuous scandals. Congress intervenes in the SEC itself much less than it could, weighing options of legislation, oversight, administrative regulation, and other tools, giving-and-taking with the SEC and other parties in ways shaped by the issue and political circumstances (Khademian, 1992; Seligman, 2003). Congressional staff made this point to us in interviews, and an individual in a related organization commented that “Congress likes to set broad parameters, likes to know that things

are being done, and then doesn't want to be bothered... Things happen when things go wrong."

Describing Congress's workings with the SEC, one of the Congressional staff members we interviewed said that:

It's a complicated relationship. If they [the SEC] endorse legislation, it can be very helpful. Essentially what happens in any particular case kind of depends on the circumstances... Certain issues lend themselves to the SEC's handling. ECNs [electronic communication systems, a trading system] and market structure are examples. We will oversee activity, but these are highly technical matters. We don't rush in to write legislation. Once you write something into a statute, it's hard to take out... Congress can use the bully pulpit effectively. It's one thing for the SEC to be less than cooperative behind the scenes, and another when they're in front of a hearing or responding to public statements by the Committee. We only have a few securities attorneys ... They have 20 attorneys, and we have three on [particular] issues, so we have to pick our spots. On mutual funds, we're going to key on them... The SEC is an independent agency, so we have to be careful about pushing them too hard. We control their budget, and they're very mindful of that.

Similarly, the national press and investigations by state officials can expose regulatory problems conspicuously, but other issues besides securities regulation compete for their attention. Our interviews with individuals active in state securities regulation stressed, for example, that state enforcement officials have diverse goals and responsibilities, and so while they could target securities regulation constantly, in practice they do so irregularly based on individual priorities. (Recall the survey of securities firms noted above that reported that 85.1% of their regulatory inquiries over the preceding 12 months came from the SEC, NASD, or NYSE, with only 7.2% from states (Securities Industry Association, 2006: 13)).

Thus, Congressional investigations, seriously damaging press coverage, or state AG investigations are influential but episodic. They shape the political environment in which national regulators and firms deal routinely with each other and in how regulatory politics play out within firms.

## THE SEC, THE SROs, AND FIRMS

The three main national securities regulators are the Securities and Exchange Commission, the Financial Industry Regulatory Authority (FINRA)—formed from a merger of the NASD and much of the NYSE’s regulatory operations in July of 2007—and NYSE Regulation, which continues to oversee NYSE market operations. A presumption in public policy since the 1930s is that the self-regulatory organizations, along with their member firms, will conduct the majority of routine regulatory operations and enforcement. The SEC oversees the system, intervening directly if self-regulation fails in a notable way. Enacting the federal securities laws in the 1930s depended on that presumption. The securities industry was vulnerable politically because of practices associated with the depression, but it could threaten complete economic collapse if legislation disrupted financial markets too abruptly. The SEC’s architects and President Franklin Delano Roosevelt had to orchestrate change in the industry while constrained by its political power. What resulted was an understanding that the industry would have to establish more extensive regulatory controls but would design them subject to SEC approval. In practice, “shared regulation” is a more accurate term than the conventional “self”-regulation, but, whatever term is used, the system’s center of gravity is in the private sector. Since the 1930s the SEC, courts and the Congress have reinforced this understanding. As noted above, in federal fiscal year 2006 the SEC initiated 75 enforcement cases involving securities firms or related individuals out of its total of 574 cases of all types, the total including cases targeting corporations issuing securities and investors (United States Securities and Exchange Commission, 2007). In comparison, in calendar year 2006 the NASD resolved 1,147 formal disciplinary cases involving securities firms and related individuals (Financial Industry Regulatory Authority, 2007b) and our NYSE data include 229 such cases.

While still relying heavily on private sector regulatory operations, the system has changed in two fundamental ways, especially over the past ten years. First, Congress gave the SEC more enforcement tools after conspicuous regulatory problems occurred. Second, self-regulatory organizations have become more organizationally independent of the markets they regulate—essentially, operating more like “private-” than “self”-regulatory organizations. These two changes, combined with the external forces outlined above and a market crisis beginning in 2001, increased regulatory pressures on firms substantially.

### **The SEC’s Enforcement Powers**

Since established in 1934, the SEC has relied mainly on civil injunctions and administrative proceedings in which securities laws violators usually consent to certain findings and sanctions. Particularly in the 1970s, the SEC tried to leverage its limited enforcement tools in creative ways until, in the de-regulatory atmosphere of the 1980s, courts and regulated parties pushed back on enforcement generally. However, responding to well-publicized cases of insider trading of the mid-1980s, Congress for the first time authorized the SEC in 1984 to impose civil money penalties and demand profit disgorgements for insider trading (Levine & Hawke, 2003; Seligman, 2003; Stewart, 1991). Then, again after visible frauds, Congress passed the Securities Law Enforcement Remedies and Penny Stock Reform Act in 1990, a law applying to violations beyond insider trading. It authorized the SEC to fine violators, to require violators to disgorge illegal profits, to issue administrative cease and desist orders without demonstrating probabilities of future violations, and to bar individuals from serving as corporate officers and directors (Coffee & Seligman, 2003: chapter 18). Finally, following scandals at Enron and WorldCom and the collapse of the internet-related stock market bubble, Congress passed the Sarbanes-Oxley Act in 2002 after little debate and with votes of 423-3 in the House and 99-0 in the Senate. The

Sarbanes-Oxley act required extensive changes in corporate financial controls, board governance, and expanded the size of the SEC, essentially giving the SEC the formal powers to pursue regulatory goals it had pursued informally in the 1970s (Levine & Hawke, 2003). While the SEC did not use its expanded enforcement powers as fully as it might have through the 1990s (Gasparino, 2005; Levitt, 2002), the new authority, combined with the fraud-related market declines discussed below, produced a major increase in enforcement after 2002.

### **Growing Organizational Independence of the SROs**

The normative argument for self-regulation is that insiders are best able to regulate firms because of their knowledge, and that they will regulate themselves responsibly if they otherwise face direct governmental control. Then-SEC chair William Douglas, emphasizing this mutuality of interests in 1937, said that “Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used” (Seligman, 2003: 185). The New York Stock Exchange and National Association of Securities Dealers—the two largest SROs—operated the two largest securities markets as well as the regulatory systems overseeing those markets for most years since establishment of the SEC.

However, even beginning in the 1930s, professional staff rather than NYSE and NASD business members gradually came to shape NYSE and NASD governance, especially in regulatory operations. Regulation and business activities tended to divide because of pressures from the SEC and a need for professional administration of expanding regulatory operations (Seligman, 2003), and members came to view such staff as internal regulators rather than as “representatives” overseeing regulation. In 1995 one senior industry attorney rejected a characterization of the NYSE as “the industry” by saying “The New York Stock Exchange is not

the industry. They're regulators. They don't speak for the industry. The Securities Industry Association speaks for the industry" (McCaffrey & Hart, 1998: 78).

Still, regulation informed by business knowledge remained self-regulation's justification, and the SROs' business and regulatory operations operated side by side. After the mid-1990s, SEC charges that the NASD and then NYSE had tolerated violations in their market operations prompted reorganization of self-regulation. In 1996 the SEC charged the NASD with failing to control pricing collusion among dealers on its NASDAQ market (United States Securities and Exchange Commission, 1996). The NASD responded first by dividing the organization into business and regulatory divisions, more fully insulating regulation from business oversight. Then, after several years of discussions, and for both business and regulatory purposes, the NASD and NASDAQ separated in 2004. The NASD would operate solely as a regulatory organization overseeing the NASDAQ and other markets under contract. One senior regulator commented to us in an interview that "The NASD reorganization changed the culture of the place," saying that the NASD now functioned more as a "private regulator rather than a self-regulatory organization," and that it "used to have a grand jury system with industry members voting on whether or not to bring a case. Now, the staff has total discretion, not needing the members' approval."

At the same time that the NASD-NASDAQ were separating, investigations by the SEC and the press in 2003 publicized deficiencies in NYSE oversight of its floor operations, leading to SEC charges in 2005 (Cohen & Kelly, 2003; United States Securities and Exchange Commission, 2005). Critics, including the NASD, argued that the NYSE ought to divest its regulatory operations because of a tension between running a market while regulating it, just as the NASD had split from NASDAQ. Securities firms belonging to both the NYSE and NASD in

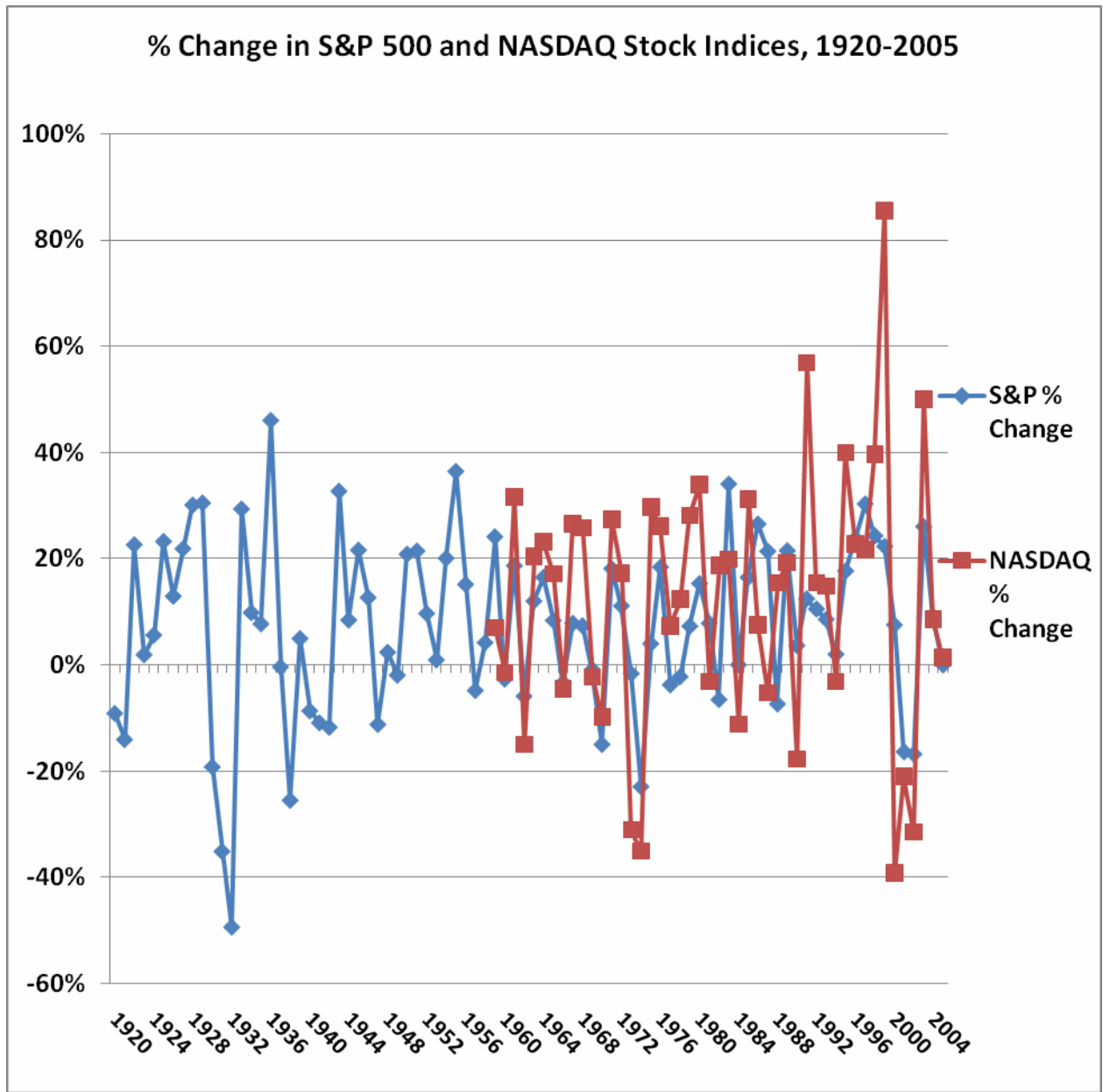
recent years had objected to oversight by two major private regulators with overlapping rules and examinations, and also pushed for merger of the regulatory operations (R. Smith, Luchetti, & Craig, 2006; United States House of Representatives Committee on Financial Services, 2005).

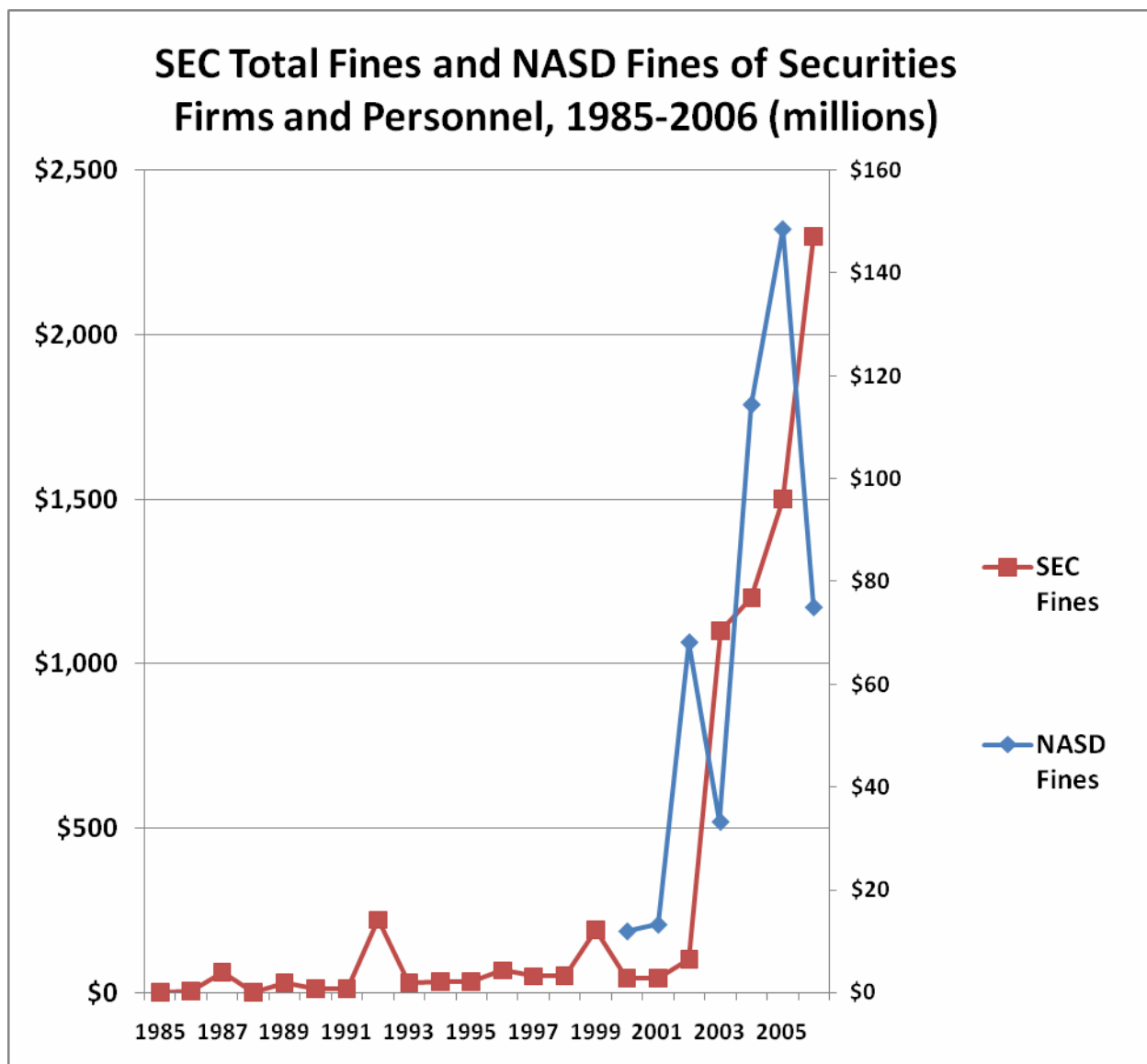
The NYSE responded by reorganizing so that regulation reported to a separate NYSE regulatory governance board, much as the NASD had restructured its operations following its price collusion charges (United States House of Representatives Committee on Financial Services, 2003b). The NYSE also replaced its regulatory management with new executives who urged Congress and the SEC that they be given a chance to operate the new structure before any divestment of the NYSE's regulatory operations (Der Hovanesian, 2004; United States House of Representatives Committee on Financial Services, 2005).

Nevertheless, in 2006 the NASD and NYSE announced that they would merge their member regulation operations—the largest share of their regulatory activity—to form the Financial Industry Regulatory Authority (FINRA), a merger taking place formally in July of 2007, with NYSE Regulation retaining oversight of its market operations. Congress, the SEC, and major securities firms jointly pressed for this merger (R. Smith & Scannell, 2006). The charges of regulatory problems at the NYSE in 2003, the new model of the NASD as a private independent regulator, and concerns about the efficiency of U.S. securities regulation combined to facilitate this restructuring of securities regulation. The business leadership of the NYSE did not seem to resist the change; large securities firms that were important to the NYSE's corporate strategy advocated it because it would consolidate member firm regulation. The NYSE's regulatory leadership seemed to concede, though not welcome, the divestment of member firm regulation and enforcement; several of its key executives assumed leadership positions in the new organization, with their offices and staff continuing to operate at the NYSE site.

## **Market Crises and Regulatory Changes**

Market crises make regulatory change more likely. Figure 2 below indicates the percentage change in the S&P 500 and NASD (over-the-counter) stock indices from 1920 through 2005. Corporate fraud contributed to two of the three periods of greatest percentage decline, and those produced the original federal securities laws in 1933 and 1934 and the Sarbanes-Oxley Act in 2002. SEC fines for violations—whether or not they involved securities firms—increased sharply in 2002, as did the NASD’s fines for securities firms and related individuals (figure 3).





**SOURCE: SEC and NYSE Annual Reports. NASD data prior to 2000 combine “regulatory fees and fines” and so only data 2000 to present are reported.**

The NYSE enforcement data provide more detail than the aggregated SEC and NASD data; Table 1 highlights selected patterns from 1990 through 2006. Beginning in 2003, the NYSE filed cases against firms more frequently and levied heavier fines. The table shows the fines reported for all cases involving firms, including enforcement actions conducted jointly with the SEC, NASD, and/or states, and for cases in which the NYSE was the only participating

**TABLE 1: FINES AND SUPERVISORY CHARGES ISSUED AGAINST FIRMS IN NYSE  
FORMAL DISCIPLINARY ACTIONS, 1990-2006**

Year	Total NYSE Formal Cases	Cases Involving Firms	Total Fines for Firms, Including Joint Cases	Total Cases With Fines for Firms, Incl. Joint Cases	Total Fines for Firms Excluding Joint Cases	Cases With Fines for Firms, Excl. Joint Cases	Total Cases for Firms Specifying Failure to Supervise	% of Total Cases for Firms Specifying Failure to Supervise Among Violations
1990	183	21	\$3,648,500	20	\$3,648,500	20	11	52.4%
1991	209	25	\$2,332,500	25	\$2,332,500	25	15	60.0%
1992	187	23	\$3,920,000	20	\$3,920,000	20	7	30.4%
1993	186	22	\$1,077,500	19	\$1,077,500	19	8	36.4%
1994	169	15	\$836,500	15	\$836,500	15	11	73.3%
1995	182	17	\$2,435,000	17	\$2,435,000	17	13	76.5%
1996	148	16	\$1,675,000	15	\$1,675,000	15	11	68.8%
1997	179	11	\$810,000	9	\$810,000	9	8	72.7%
1998	147	17	\$3,000,000	17	\$3,000,000	17	12	70.6%
1999	171	24	\$3,165,000	21	\$3,165,000	21	16	66.7%
2000	225	29	\$4,472,500	25	\$4,272,500	24	22	75.9%
2001	230	32	\$3,190,000	31	\$3,190,000	31	23	71.9%
2002	249	34	\$5,422,500	30	\$2,672,500	25	26	76.5%
2003	220	57	\$1,402,961,000	55	\$7,961,000	43	47	82.5%
2004	192	48	\$197,084,414	48	\$23,680,000	36	45	93.8%
2005	195	57	\$135,887,500	57	\$25,387,500	52	54	94.7%
2006	229	81	\$30,185,319	77	\$26,535,119	74	75	92.6%

regulator. The fines for all cases overstate NYSE-specific fines because they include cases in which it was only one of the participants, including the \$1.4 billion settlement of investment banking conflict of interest cases in 2003; fines for cases brought by the NYSE alone indicate more clearly its tendencies to levy penalties on firms. Both total fines and fines involving just the NYSE as participating regulator increased substantially since 2002. In addition, the cases charging firms now routinely single out supervisory failures as violations, indicating how it emphasized firms' managerial obligations and any related failures in enforcement proceedings.

Thus, over the past twenty years the SEC's enforcement authority increased substantially, and in the past ten years the self-regulatory organizations became more independent of the markets they are charged with regulating, turning them more into "private-" than "self-regulatory" organizations. These changes, combined with market crises associated with regulatory failures, sharply increased regulatory pressures in financial markets after 2002. Yet, tendencies to regulate aggressively run into the discrepancy between regulatory accountability and regulatory authority. Regulators and firms are highly interdependent, and this shapes how they constantly negotiate regulatory policies and outcomes; the next section discusses this system.

### **THE NETWORK OF POLICY AND MANAGEMENT IN SECURITIES REGULATION**

A main problem for financial regulators is managing discrepancies between their accountability and their resources (Khademian, 2002a). SEC Chair Christopher Cox commented to the House Appropriations Committee in 2007 that "About 3,600 staff at the SEC are responsible for overseeing more than 10,000 publicly traded companies, investment advisers that manage more than \$32 trillion in assets, nearly 1,000 fund complexes, 6,000 broker-dealers with 172,000 branches, and the \$44 trillion worth of trading conducted each year on America's stock

and options exchanges” (Cox, 2007). The Financial Industry Regulatory Authority has about 3,000 employees focusing on securities firms, and, as noted earlier, the predecessor organizations NASD and NYSE Regulation resolved 1,376 formal enforcement actions involving securities firms and related personnel in 2006 compared to 75 such cases initiated by the SEC in FY 2007. Still, in 2007 FINRA oversees 5,029 member organizations with 174,045 branch offices and 672,979 registered personnel, and so has to manage the discrepancy between resources and activity for which it is responsible just as the SEC does (Financial Industry Regulatory Authority, 2007b; United States Government Accountability Office, 2007b). Furthermore, the technical complexity of in some areas of securities markets challenges control systems within the firms themselves, and usually overwhelms external regulators (Bookstaber, 2007). This situation means that regulators and firms have to cooperate to a large extent if they want to avoid serious problems.

Congress, the press, and others hold regulators accountable when breakdowns occur, and so regulators have incentives to push firms to comply with rules. Echoing statements in multiple interviews, a senior regulator commented to us that “We learned a lesson from the conflicts of interest case. We felt very burned by [New York State Attorney General Eliot] Spitzer. We need to figure it out early and get it early when there is an emerging problem.” Also, individual regulators vary in how they pursue violations and levy penalties, and some are particularly committed to strong regulation (Levitt, 2002). On the other hand, regulators need firms’ cooperation in investigations and enforcement. They warn firms not to make inspections and investigations more difficult by presenting information selectively or other tactics, tell firms that they will consider favorably firms’ cooperation beyond legal requirements when assessing penalties, and are aware of how firms can impede their work if firms regularly opt to formally

challenge regulatory actions (Financial Industry Regulatory Authority, 2007a; Flannery & Shin, 2007: 5; Rubin & Cannon, 2005; United States Securities and Exchange Commission, 2006).

For their part, regulated firms are aware of the risks of regulatory penalties. A study of 2,206 individuals involved in SEC or Department of Justice enforcement actions involving financial misrepresentation from 1978 through September 2006 found that 93% lost their jobs by the end of the enforcement period (Karpoff, Lee, & Martin, 2007). Our analysis of the NYSE's formal enforcement cases from 1990 through 2006 indicates that about 60% of the cases involving individual respondents referred to the individuals being "terminated" or "permitted to resign" by their firm in connection with the events involved in the enforcement action; from the case discussions we suspect that this was the case in many other instances but the information was not reported. Our interviews referred repeatedly to the reputational costs of regulatory actions for firms, and what the SEC and SROs *could* do if they choose to focus on a firm underlay most of the discussions at the regulatory conferences.

So, regulators who want their work to go smoothly depend on firms cooperating with them in routine examinations, policymaking, and enforcement. In turn, firms and individuals are aware of how much regulators can harm them and want to be sufficiently credible to get the benefit of the doubt in regulators' judgment calls while simultaneously dealing with them from strong positions. The individuals involved recognize their interdependence and usually know and expect to be dealing with each other in the future, and perhaps on "the other side." Regulators, firms, and related individuals therefore informally settle the overwhelming majority of enforcement cases brought by the SEC and SROs. Rubin and Cannon estimate that more than 96 percent of NASD disciplinary actions were settled rather than litigated to conclusion (Rubin & Cannon, 2005: 782). Of the 3,301 NYSE disciplinary cases that we reviewed, 70% of the

respondents settled and in 22% of the cases the respondents simply did not appear before the panel and were found guilty by default.

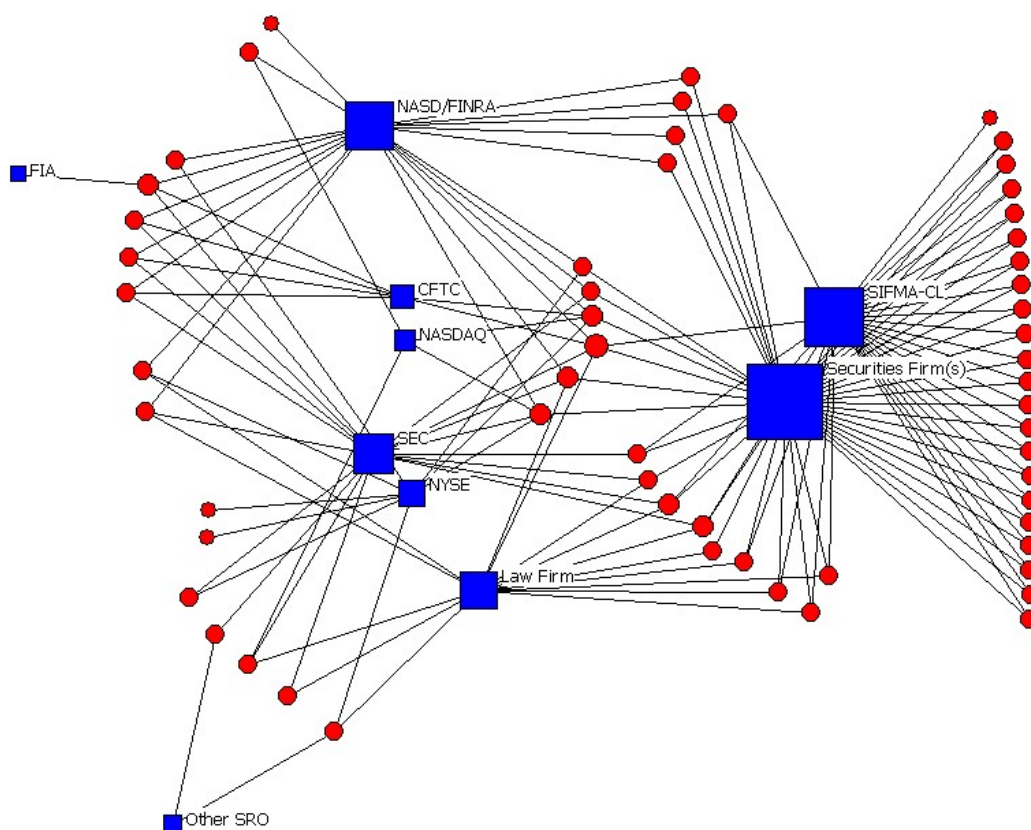
Legal and compliance personnel and managers in firms try to improve the terms of the settlements by handling cases in ways, and building organizational and personal reputations, that might persuade regulators to lower or even not impose penalties. Those we interviewed stressed the importance of informal relationships to acquiring information and influencing others in this system, one going so far as to say (probably overstating the point) that “relationships are everything.” Hiring practices reflect this system and reinforce it; being respected by the other side is a major career advantage (Craig, 2004; United States Senate Minority Staff of the Senate Committee on Finance and Committee on the Judiciary, 2007: 24-36).

To illustrate this theme, Figure 4 presents a diagram of an affiliation network of individuals active in securities regulation. The figure represents a network of individuals working in securities regulation composed of 60 individuals. Actors included in the sample are individuals holding leadership positions in the SEC, the NYSE, the NASD, FINRA (the merger of the NASD and key components of NYSE Regulation), the Compliance and Legal division of the Securities Industry and Futures Markets Association (SIFMA-CL), and a small sample of individuals who were interviewed. The network above links individuals with related organizations at which they have been affiliated at some point in their careers.

Individuals are represented by red circles and organizations are represented by blue squares. The size of the node indicates the node’s centrality measured by degree. The larger the node, the more connections the node has, and thus the more “central” the node is in the system. So, for example, the node for Securities Firms is the largest because this node has the most individual nodes connected to it. Along the same lines, there are several individual nodes that are smaller than all others because they each have only one connection. The picture was created

using the Gower Metric Scaling Layout in NetDraw software (Borgatti, 2002). The Gower Metric Scaling layout places nodes close to each other if the nodes have intense relations either directly or indirectly (Parhi, 2005).

FIGURE 4: Affiliation Network for Individuals Working in U.S. Securities Regulation



This figure suggests two things. First, there are clusters of organizations. SIFMA-CL and Securities Firms are placed very close together. SIFMA is the primary association for the securities industry, SIFMA-CL and the firms obviously should be connected by many links. While not as tightly clustered, organizations with regulatory duties appear to be grouped in a vertical line on the left side of the diagram (NASD/FINRA, CFTC, NASDAQ, SEC, and NYSE).

Other SROs and the Futures Industry Association (FIA) are on the fringes of the diagram because, while important in their own area of financial markets, they are not as central as these organizations in securities regulation.

Second, there are clusters of individuals. There appears to be three general types of individuals here: those primarily linked with industry, or with regulatory organizations, and spanners. Those distinctively connected with industry are on the right side of the diagram, linked primarily to SIFMA-CL and Securities Firms. The regulators are on the left side of the diagram, not as tightly clustered as the industry individuals, and are linked primarily to the variety of regulatory organizations. The spanners are in the center of the diagram and appear to be in three groups. First, there is the group at the bottom that connects industry with regulatory personnel, primarily through law firms and to some extent the SEC. Second, there is the group in the middle that connects the industry to the regulators primarily through the SEC and the NYSE and to some extent Law Firms, NASDAQ, and the CFTC. Third, there is the group at the top that connects the industry to the regulators primarily through NASD/FINRA.

Spanners are an important group in this system, especially as a source for information exchange and bridging the perspectives of industry and regulators. Interviews emphasized the importance of informal exchange of information across regulatory and industry organizations and such individuals likely help this exchange. Also, we interviewed several individuals having backgrounds at both regulatory and industry organizations, and they shifted easily back and forth between the perspectives, a quality that facilitates inter-sectoral collaboration (Faerman et al., 2001).

The social context in which regulators, firms, and the individuals involved deal with each shapes behavior in this system (McCaffrey et al., 2007). Yet, as discussed above, external

pressures from market forces, private litigation, Congress, state governments, and the media—particularly when they are fraud-facilitated market crises—clearly prompted major regulatory changes (recall Figures 3 and Table 1 showing the striking increase in regulatory penalties after 2002). The social networks outlined in Figure 4 existed prior to 2002, but external forces combined with them to change how regulation operated within firms (Burke, 2006; Securities Industry Association, 2006). Richard Ketchum, the Chief Regulatory Officer of the New York Stock Exchange, while noting improvements in firms' compliance programs, indicated the recurring questions in 2005:

But, let me leave you with some of the higher levels of questions that I hope you, your business heads and your CEO are regularly asking:

Is the access of Legal and Compliance to senior management regular and systematic, or is it ad hoc and episodic? Even if regular, does it involve a full analysis of compliance developments and exposures, or is it cursory?

Is your commitment to providing technology resources equally as great for compliance as it is for any new trading, sales or merchant banking initiatives? Have you gone back and analyzed the compliance technology proposals that didn't receive approval in prior budgets to see if the exposure is still there?

Have areas such as fixed income, stock loan and operations received the same level of compliance attention as equities and investment banking?

Does your firm evaluate compliance risks with the same rigor and self-criticality with which you analyze market, operational and financial risk? In that connection, how much of what you have learned positively from your Sarbanes-Oxley review of financial controls provide lessons with respect to compliance?

Finally, how much attention have you paid to escalation issues? Are your employees truly rewarded for raising for what they perceive as compliance issues, or is it at best, simply tolerated (Ketchum, 2005)?

“Hard” external pressures and “soft” social forces both help determine how these regulatory politics play out within firms.

Prior research in other areas of regulation also indicates that firms sustain effective regulatory programs only when facing tight external oversight. Regulation's primary justification is that unregulated firms push production and sales to the detriment of worker safety, environmental protection, or other purposes that slow production and sales, causing social harms. Firms' "voluntary" regulatory programs are as much responses to pressures as voluntary initiatives; firms are more likely to have them in challenging regulatory and political environments, and the programs affect firms' regulatory performance mainly when third parties audit them (Anton, Deltas, & Khanna, 2004; Lubell, 2004; Pfaff & Sanchirico, 2004; Potoski & Prakash, 2005a, 2005b; Rees, 1997; Stafford, 2007). Voluntary initiatives tend to decay when they do not generate net economic benefits for the firm and supporting external pressures are erratic; such efforts are more stable when the economic partners of firms, such as those to whom they supply goods, require higher environmental standards for their own purposes as part of a contract (Andrews, Hutson, & Edwards, 2006; Johnston, 2006; Vogel, 2005). As Gunningham et al. note regarding a firm's failed move to totally chlorine free [TFC] technology not required by regulations, "As interpreted by the enforcers of the economic license—investors, lenders, and financial analysts—the economic license does not encourage a firm to invest in very costly environmental measures or technologies that do not improve productivity and profits unless government regulations assure that the firm's competitors will be compelled to make similar expenditures" (Gunningham, Kagan, & Thornton, 2004: 336). Strong external regulatory pressures thus raise the average level of compliance in an industry and narrow the range of performance among its firms. Firms wanting to stay in business have to meet higher minimum standards, raising the firms at lower levels, while, as noted above, higher performing firms may

improve their own performance but do not have strong incentives to go “beyond compliance” (Kagan et al., 2003).

However, managerial choice within organizations also is important; firms vary substantially even within this narrower band of performance. Studies of regulatory compliance find differences among firms in attitudes toward regulation and compliance not explained statistically by measures of technology, economics, or formal organizational structure, beyond a fairly consistent finding that upper executives’ commitment to preventing violations tends to reduce them (Agrawal, Jaffe, & Karpoff, 1999; Alexander, 1999; Alexander & Cohen, 1996, 1999; Gray & Shadbegian, 2005; McKendall, DeMarr, & Jones-Rikkens, 2002; McKendall & Wagner, 1997; Stanwick & Stanwick, 1998; Weaver, Treviño, & Cochran, 1999a, 1999b). Pfaff and Sanchirico observe that when studying whether or not firms voluntarily disclose environmental violations “it seems important to keep in mind that firms’ decisions to disclose are conscious choices that are likely driven by their perceived best interests” (Pfaff & Sanchirico, 2004: 426). But the consistent finding that managerial behavior toward regulation varies suggests that the choices that are in firms’ best interests usually are not obvious, and politics within the firm, dealings with regulators, and external pressures interactively determine them.

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