“Then Let’s Have a Dialogue”: Interdependence and Negotiation in a Cohesive Regulatory System

David P. McCaffrey
Amy E. Smith
University at Albany, State University of New York
Ignacio J. Martinez-Moyano
Argonne National Laboratory

ABSTRACT

Public and private organizations deal closely with each other on regulatory issues. Newer forms of regulation rely on shared enforcement and supervisory responsibilities, regulatory negotiation, and other methods that try to get beyond remote public commands while maintaining effective public involvement. This article examines how regulators and firms deal with each other, the interdependence that forms between them in the course of their work, and the benefits and liabilities of the strong ties that may develop out of this interdependence. We use the securities industry as a context for discussion but indicate that the points apply more generally. We pay special attention to the potential benefits and risks of cohesive regulatory networks. Regular dealings among regulators and firms outside of regular rulemaking or enforcement proceedings enhance cooperation, reduce information disparities, strengthen regulatory cultures, and arguably lower the threshold of external pressure required to effect changes within firms. The conditions enhancing these benefits, however, also will restrict the flow of information, perspectives, and criticism from outsiders, potentially leading to erosion of performance standards and eventually serious problems. We describe the circumstances under which these tensions are more likely to be managed without damage from these problems and the broader implications for research and teaching in public management and policy.

Federal securities laws passed in the 1930s explicitly established a sharing of regulation between the public and private sectors. The Securities and Exchange Commission (SEC) oversees private self-regulatory organizations (SROs) such as the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) but has the authority to control the SROs directly if required. The SROs oversee, and similarly can set rules for, financial firms like Merrill Lynch, Morgan Stanley, and Citigroup that are members of the SROs because they need access to the SROs’ markets. The SEC and the
self-regulatory organizations rely heavily on the firms’ internal control systems to prevent securities law violations on the grounds that the firms are in the best position to oversee their own operations and can impose various sanctions when the firms’ systems fail. High levels of growth and innovation in U.S. securities markets since the 1930s indicate, overall, that this regulatory system provides the market stability and transparency intended by the securities laws (Seligman 2003).

But, as in other areas, enough problems occur to indicate the hazards of regulatory implementation. The recent past is a case in point. Stock market value increased dramatically after 1994 before declining sharply from 2000 to 2002 with the collapse of the “Internet bubble.” Firms, regulators, and investors relaxed controls when it seemed difficult to lose money in the stock market (Shiller 2001). After the market collapse of 2000–2002, various financial firms consented to legal findings that they had helped Enron and other corporations skirt accounting rules, encouraged their investment analysts to exaggerate corporations’ values in order to win the corporations’ investment banking business, violated or at least bent rules on mutual fund operations, and generally aggravated corporate governance breakdowns. The Sarbanes-Oxley Act of 2002 produced extensive new requirements for internal controls, and self-regulatory organizations strengthened their supervisory requirements (Gasparino 2005; Klein et al. 2005; U.S. Government Accountability Office 2005a; U.S. Senate, Committee on Banking, Housing, and Urban Affairs 2003). Although the regulatory dynamics of the past five years are striking, comparable events occurred in other periods, and so the material here applies more generally. One attorney with extensive experience as a regulator and industry advisor suggested in an interview with us in December 2003 that “the nature of change is cyclical. I’ve seen plenty of crises. It may be that the pressures now are somewhat more intense than in other crises. You had a perfect storm developing in the Internet bubble. But . . . there are ebbs and flows to these things.”

This article discusses how regulators and firms deal with each other in this system and the implications for regulatory policy and management in general. Centralized design and enforcement of rules always will be an important part of regulation, and regulators’ legitimacy and latitude in judicial and administrative proceedings are important advantages when they deal with firms (Mashaw, Merrill, and Shane 2003). Nevertheless, it simply is not possible for regulators to oversee directly the large volume of private transactions for which they are responsible. Furthermore, regulators cannot understand the industry’s technology as well as firms because firms work with the technology constantly and regulators do not, and administrative procedures reduce this disparity only slightly (Breyer 1982).

Accordingly, regulators depend on firms’ internal controls operating reasonably effectively to avoid being overwhelmed with regulatory breakdowns. Viewed more positively, regulators who can depend on firms’ internal controls can apply their resources to those tasks for which there is no good substitute for direct governmental action. Analysts have noted agency-firm interdependence across the wide range of regulated industries, including pharmaceuticals (Braithwaite 1984; Hawthorne 2005), nuclear power (Marcus and Majumdar 2001; Rees 1994; U.S. General Accounting Office 1991; U.S. Government Accountability Office 2005b), construction (May and Wood 2003), banking (Khademian 1996), and, as we will discuss in more detail below, the securities industry (Khademian 2002). Understanding how relationships between regulatory organizations and firms affect compliance thus is essential to understanding regulatory implementation. Also, newer
forms of regulation try to develop good-faith working relationships between regulators and firms, in which regulators reward firms’ legitimate efforts to comply voluntarily with rules with more flexible enforcement (Ayres and Braithwaite 1992; May 2002). Several organizational, political, and legal factors inhibit diffusion of such initiatives, but their persistence indicates their appeal at least to the agencies’ leaders (Coglianese and Nash 2001; Nash and Ehrenfeld 2001; O’Leary and Raines 2003; Pfaff and Sanchirico 2004; Rees 1988; Shapiro and Rabinowitz 1997; Zimmerman 2005). How regulatory relationships operate in practice indicates the likely benefits and hazards of these newer approaches.

Moreover, what we learn about such regulation arguably applies to public management generally. Public management increasingly involves overseeing and coordinating public, nonprofit, and private organizations that jointly produce activities affecting public welfare. Formal legal responsibilities, incentives, and social factors interactively determine how effectively organizations in different sectors cooperate to deal with these tasks (Kettl 2002; Milward and Provan 2000). How regulators and firms deal with each other in this network of formal and informal relations is one instance of the larger story of how public management operates today, so an understanding the patterns discussed here is useful for those who research, teach, or practice in areas well outside financial market regulation.

The article is organized as follows. The next section discusses regulator-firm interdependence generally and the trade-offs of the cohesive relationships potentially developing within it. We then describe the data obtained to study these processes in the securities industry. After discussing how these processes operate in this setting, the article considers the broader implications for research and teaching in public management and policy.

**BENEFITS AND RISKS OF COHESIVE REGULATORY RELATIONSHIPS**

Professionals in regulatory organizations and private firms engage each other, directly and indirectly, on an almost daily basis (Ayres and Braithwaite 1992; May 2002; Sparrow 2000). Formal rules, organizational responsibilities and jurisdictions, power dynamics, and instrumental calculations obviously influence what transpires, but regulators and firms do not act just on the basis of what they can and cannot get away with instrumentally (March, Schulz, and Zhou 2000). The interplay of rationally calculated action based on self-interest with behavior motivated by social expectations and relationships fundamentally shapes how they deal with each other (March and Olsen 1989; Smelser and Swedberg 2005).

Firms and regulators routinely act tactically. Regulated individuals and firms assess the costs and benefits of levels of compliance and cooperation with regulators. In turn, regulators intervene in firms based on the available resources, the importance of the underlying violations, their sense of the political and legal environment and the firms’ reactions, and so forth. External legal and political threats, such as the public and congressional outcries following the collapse of Enron, affect these calculations. Furthermore, individuals know that being seen as effective in either the public or private sectors helps their career options in their current organization and with prospective employers (Davis and Craig 2005; Quirk 1981).

But how regulators, firms, and the individuals involved deal with each other depends as well on their familiarity and joint experiences and the norms and expectations at the individual and organizational levels (Zaheer, McEvily, and Perrone 1998). As March, Schulz, and Zhou (2000, 6–7) put it, parties act based on “a logic of appropriateness”
as well as a “logic of expected consequences.” Elinor Ostrom (1998, 6) notes that “consistent, strong, and replicable findings are that substantial increases in the levels of cooperation are achieved when individuals are allowed to communicate face to face.” Regular dealings among agencies, firms, and associations outside of specific rulemaking or enforcement proceedings can deeply affect their working relationships. The ongoing contact means that individuals who oppose each other in a particular case know that they will be dealing with each other in the future, and this influences how they behave in the moment. They develop understandings about reasonable regulatory behavior and “appropriate” ways to interact, and as we will see below, individuals from firms and regulatory agencies regularly refer to the importance of “dialogue” and “relationships” (Axelrod 1984, 1997; Posner 2000).

A social network of public and private organizations and related individuals influences how regulators will deal with firms and how firms will respond to regulators. These networks vary across areas of regulation. Ties among affected firms, private industry associations, and government may not affect some areas very much. In other areas, however, the formal and informal connections among firms, other private parties, and government agencies have formed into more cohesive “regulatory communities” that fundamentally shape regulation (Meidinger 1987).

Laws may produce this regulatory community. For example, law establishes professional self-regulation—actually, a “sharing” of regulation—involving government, professional licensing boards, and associations (Michael 1995; Schuchman 1982). In other areas industry associations and firms have established voluntary private regulatory agreements explicitly backed up by social and political pressure among firms, and government interacts closely with these private initiatives. The Institute of Nuclear Power Operations actively oversees nuclear power plants, so much so that it prompted congressional questions about its role vis-à-vis the Nuclear Regulatory Commission (Rees 1994; U.S. General Accounting Office 1991). The Responsible Care Initiative of the Chemical Manufacturers Association is another effort to get firms to comply with industry-wide standards of regulatory conduct. Some observers have called Responsible Care a landmark initiative by the chemical industry to collectively take responsibility for better environmental controls, while others consider it a relatively weak system of exhortation, but either way it is a core part of how chemical regulation operates in the United States (Coglianese and Nash 2001; King and Lenox 2000; Rees 1997).

Cohesive regulatory networks produce advantages and hazards for management and policy. We discuss both below.

Potential Advantages of Cohesive Regulatory Networks

Conferences, working groups, and informal communications provide settings in which those within firms who are responsible for regulation, joined by regulators, become familiar with each other (McCaffrey and Hart 1998; Rees 1994, 1997). The extensive communication between public and private organizations diminishes the gap in information between industry insiders and public regulatory agencies. The regular contact helps create an “identity as regulator/compliance professional”—a common perspective, reinforced by occupational interest, that regulation is a core task facing industry—spanning the public and private sectors (Dietz and Rycroft 1987; Haas 1992; Makkai and Braithwaite 1993; Parker 1999; Trice 1993). Since individuals know that they will be dealing with each other
In the future, they are less likely to cheat and more likely to cooperate (Axelrod 1984, 1997). They develop understandings about reasonable regulatory behavior and appropriate ways to deal with each other (Posner 2000).

In these settings the various parties can signal to each other candidly what they really want and what they can live with. A regulatory organization with strong ties in a network can communicate credibly and effectively to firms, provided it also maintains a reputation for independent judgment (Breyer 1993; Carpenter 2001; Evans 1995). Compliance personnel within firms then can communicate regulators’ expectations to firms’ managers, and they have professional and personal interests in managers hearing those signals clearly (Parker 1999). Also, people move freely across the sectors—a person in industry may have worked in government, and a regulator may have an industry or private legal background—so they are familiar with each sector’s perspective (Quirk 1981).

This ongoing cooperation lowers the threshold of external pressure required to effect changes within firms because people do not necessarily subject choices to a strict self-interested cost-benefit test (Parker 1999). From a more sociological point of view, people acting based on their evaluations of others’ credibility and what they believe is expected of them reflects “norms of obligation and cooperation . . . [implying] the existence of some sort of community of shared values” (Bradach and Eccles 1989, 107). From a more economic point of view, it reflects information acquired through repeated experience that enables them to deal with governance problems (Williamson 1996, chap. 10). From either perspective, it means that one has to consider how the social context influences the ways people respond to interests and incentives and, especially, that one cannot predict behavior just by identifying economic, political, or legal incentives and assuming that people are going to act accordingly. This is good news for effective regulation because otherwise it would be even harder to change behavior within firms that inherently have superior access to information and incentives to resist regulation.

Potential Liabilities of Cohesive Regulatory Networks

Cohesive ties produce potential hazards as well as benefits. A network becomes cohesive because its members focus on each other far more than outsiders; what enhances cooperation among an inside group of regulators, firms, and industry associations also will lead them to pay less attention to organizations outside the central group. This will restrict the flow of information, perspectives, and criticism from outsiders (Brass et al. 2004; Gargiulo and Benassi 2000; Uzzi 1997).

In addition, regulators with limited resources necessarily address some problems rather than others, and behavioral dynamics within the network influence how they allocate their attention. They can come to accept particular performance problems as low priority or “normal” because the problems do not seem to be especially harmful and targeting the problems would disrupt the work of those within the industry—with whom they must deal constantly—without clear regulatory benefits; it is hard to constantly confront questions like “Why in the world are you wasting your time and ours on that?” This is not simply “regulatory capture.” We are referring to a more subtle process in which even active and responsible regulators in a cohesive network of regulatory organizations and firms may come to tolerate an underside of business given what they see as needs to set priorities for surveillance, enforcement, and policy. Rasmussen described how those embedded within a system may gradually reduce their expectations around certain areas of performance until
a significant accident or other type of breakdown is likely to occur, describing shipping and nuclear power as examples (Rasmussen 1997; see also Perrow 1984). Similarly, Diane Vaughan (1996, 1998) outlined how such social processes can lead to “routine nonconformity,” analyzing the Challenger accident as a case in point (Vaughan 1996, 1998, 1999). As we will see in this article, these processes help explain the buildup of business practices in investment banking and mutual funds that eventually resulted in major regulatory actions provoked by someone operating outside the central network of regulators and firms, New York state attorney general Eliot Spitzer (Gasparino 2005; U.S. Government Accountability Office 2005a).

Ideally, in regulation, technically skilled insiders from the public and private sectors handle issues legally and avoid destructive, stalemating conflicts; Congress, the press, and other outside groups and organizations pay enough attention to regulatory insiders to push them to address serious problems the insiders may come to neglect for whatever reason; and those on the inside respond to external pressures in sufficiently open-minded and effective ways to develop and preserve their reputations for informed, credible judgment (Breyer 1993; Carpenter 2001). This article examines how regulators rely on firms, how firms respond to regulators, and the conditions that make it more and less likely that this system as a whole will approach this ideal.

**DESCRIPTION OF THE REGULATORY SYSTEM FOR THE SECURITIES INDUSTRY AND INFORMATION USED IN THE ANALYSIS**

The public and private sectors formally share regulation under federal securities laws passed in the 1930s. The Securities and Exchange Commission regulates firms directly but usually relies on self-regulatory organizations—mainly the National Association of Securities Dealers and the New York Stock Exchange—for routine inspections and enforcement. The SEC and self-regulatory organizations in turn rely heavily on the firms’ supervisory systems because they are closest to regulated operations, and the SEC and SROs sanction firms if their internal systems fail in some important way (Coffee and Seligman 2003; Hazen and Ratner 2003; Seligman 2003). State organizations also regulate securities firms, although they do so as a parallel system. This article focuses on the SEC, NASD, and NYSE and their dealings with firms, but it does discuss the important question of how state regulation affects behavior in this federal system.

Numbers of enforcement actions put in perspective how heavily the SEC relies on the NASD and NYSE to oversee securities firms’ operations. In federal fiscal year 2004 the SEC initiated 141 enforcement cases involving securities firms or related individuals out of its total of 639 cases of all types (U.S. Securities and Exchange Commission 2004). In comparison, in calendar year 2004 the NASD resolved 1,360 disciplinary actions involving NASD firms or individual members (National Association of Securities Dealers 2004), and our data, discussed below, indicate that the NYSE concluded 190 such cases resulting in penalties.

Between November 2003 and May 2005 we interviewed twenty-four individuals involved directly in or overseeing this regulatory system, with all the interviews at the executive or senior staff levels and lasting between one and two hours. They consisted of three from the SEC, three from the NASD, seven in senior legal and compliance positions across four large securities firms, one from an outside attorney who advised firms, two with state regulatory officials from different states, three with individuals with relevant
congressional committees, and five with the Government Accountability Office in a group interview. These interviews focused on the individuals’ perceptions of the key parties involved in securities regulation, the nature of their working relationships with the other parts of the system, and central 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.

Between November 2003 and March 2006 the first author observed the meetings of six professional conferences on securities regulation. These were a one-day seminar in September 2004 on legal and compliance issues sponsored by the Compliance and Legal Division of the Securities Industry Association (SIA), the main private national organization of securities lawyers and compliance professionals; the three-day national conferences of the SIA’s Compliance and Legal Division from 2004 through 2006; the three-day national conference of the North American Securities Administrators Association, an association mainly of state securities regulators, in October 2004; and a two-day conference on regulation organized by the NYSE in June 2005. The single-day seminar was attended by about 300 participants, and well over 1,000 participants attended each of the other conferences; for example, more than 1,800 participants attended each of the SIA Compliance and Legal Division national conferences, 2004–2006. The quotations used here were produced from detailed notes taken during the sessions.

These conferences were especially valuable to this research. Virtually all of the registrants listed in the 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 a small number of individuals from congressional committees. Active bantering among the panelists and the audience was the norm because these were conferences of insiders. Sessions focused on what regulators expected of firms, how firms dealt with these expectations, and how they handled disagreements and tensions. Thus, the conferences were relatively unscripted “shop talk” among professionals on the inside of the regulatory system and provided perspectives different from those obtained in interviews done by outsiders such as ourselves. For example, interviewing a senior federal regulatory official for an hour is valuable, but we believe that it turned out to be equally or even more valuable to watch that official engage individuals from other regulatory organizations and firms in a larger group consisting almost entirely of professionals working in the field.

As part of a larger research project we coded all of the New York Stock Exchange’s disciplinary proceedings from 1990 through 2004 (2,875 cases), and we refer to those data here regarding various issues. Finally, the article uses reports on the securities industry by Congress, the General Accounting Office (renamed the Government Accountability Office as of 2004), regulators and prosecutors, and other archives.

THE PREFERENCES AND CIRCUMSTANCES REGULATORS AND FIRMS BRING TO THEIR INTERACTIONS

We first discuss the preferences that regulators and firms each bring to the table and then how they try to negotiate or otherwise accommodate the resulting issues.
Regulators’ Preferences and Circumstances

Public and private regulators have some incentives to regulate actively and to push firms to cooperate with them on this endeavor.

Organizational Incentives

Regulators enhance their reputations if they respond to problems visibly and effectively, as in the insider trading scandals in the 1980s (Seligman 2003; Stewart 1991; Vise and Coll 1991). Regulatory organizations also want to avoid the embarrassment of having missed serious problems. If they are seen to have failed to act against conduct that is “clearly wrong,” such as in the investment analyst conflict of interest and mutual fund cases reviewed later in this article, they usually bring cases aggressively in order to compensate (Maremont and Solomon 2003; U.S. House of Representatives, Committee on Financial Services 2003b). One senior regulator in the private sector commented to us in an interview in 2004 that after recent scandals, enforcement sweeps by the SEC “are going on like crazy... The SEC says let a thousand flowers bloom. They don’t want to miss anything... There is regulatory competition; no one wants to be seen as weak or missing anything.” An individual in the public sector described SEC enforcement as “compliance driven. After something bad has happened they get in there... They were aware of these problems along the way, but for a variety of reasons they failed to act.” (We recognize the implication that incentives favoring regulation are sometimes weak; we discuss this point later.) The increases in total fines imposed by the SEC, NASD, and NYSE, reported in table 1, indicate regulation’s intensity following the various problems in 2002 and beyond.

After 2002, Congress almost doubled the SEC’s resources, and SROs’ resources have increased steadily over the past twenty years (McCaffrey and Hart 1998; McTague 2005). However, regulators’ jurisdictions and the volume and complexity of regulated activities also have increased, and so managing discrepancies between what regulators should do and what they can do remains their central problem. In the conversations we observed for this research, regulators repeatedly stressed that one of the worst things that firms could do

---

Table 1
Fines Imposed by the Securities and Exchange Commission (SEC), National Association of Securities Dealers (NASD), and New York Stock Exchange (NYSE), 2001–2004 (in millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>SEC</th>
<th>NASD</th>
<th>NYSE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$44.0</td>
<td>$13.2</td>
<td>$4.2</td>
</tr>
<tr>
<td>2002</td>
<td>$101.0</td>
<td>$68.2</td>
<td>$3.5</td>
</tr>
<tr>
<td>2003</td>
<td>$1,100.0</td>
<td>$33.3</td>
<td>$9.1</td>
</tr>
<tr>
<td>2004</td>
<td>$1,200.0</td>
<td>$102.0</td>
<td>$61.9</td>
</tr>
</tbody>
</table>

Note: Figures do not include disgorgement of profits, costs of mandatory additional remedial steps, or other financial penalties. SEC civil money penalty figures obtained from the annual reports of the SEC for relevant fiscal years and 2004 report on enforcement statistics. SEC figures include all fines and not just those applying to securities firms or related persons. NASD figures obtained from NASD 2004 summary (National Association of Securities Dealers 2004). NYSE figures were compiled from a database of cases, 1990–2004, and exclude joint cases with SEC, NASD, or other regulators. NASD and NYSE figures are disciplinary fines for calendar years.

---

1 Representatives from the SEC, NASD, and NYSE at the conferences we observed for this research all referred frequently to their new formal systems for modeling regulatory risk and allocating resources accordingly. Unexpected scandals still affect regulatory attention dramatically, but regulators’ emphasis on formal risk management indicates their awareness of the gap between the scope of their tasks and their resources.
in working with regulators was to prolong or increase the difficulties of inspections and investigations. When asked at a 2004 industry compliance seminar, “What bothers you in dealing with firms?” one NYSE official responded, “When firms don’t cooperate, obstruct, and delay, and ask for extension after extension, making investigations more difficult.” An NASD official added, “I will duplicate the point. . . . We are concerned with moving rapidly. You have read the papers and know our focus. . . . You should make sure that you respond properly. If you can’t respond, let us know. If you have issues with the case, make sure you move up the line [at the NASD in seeking clarifications].” She continued, “We have experienced the situation [in which] . . . we asked for documents and find out two months later a slew of emails didn’t get produced. . . . [W]e look very askance at the withholding of documents. We’ll issue [related] charges and summary fines, and increase any eventual fines.” In another panel session, an NYSE staff member said, “Regulators are reasonable people. We’re on the same side. You have a business to run, and we have a job to do. It’s a matter of professional courtesy and managing expectations. Nothing drives a regulator more crazy than to be told a document will be there by the end of the day, and two days later it’s still not there. . . . You need to follow through because you don’t want to be on the front page of the Wall Street Journal.”

**Career Satisfaction and Prospects for Individual Regulators**

Individuals have incentives to establish reputations as engaged, effective professionals because, in addition to the intrinsic satisfaction of doing good work and avoiding public criticism, this improves their career prospects. As Paul Quirk (1981) found in a study of regulators in various areas, firms generally prefer to hire widely respected former regulators rather than those with reputations for industry bias or passivity. Securities regulators have substantial discretion in the cases they bring and associated penalties. Firms get more access to and knowledge of the regulatory organization and more credibility in related discussions when they hire such individuals (Davis and Craig 2005). Based on the biographies of the panelists at the conferences observed for this research and our interviews, we suspect strongly that the vast majority of senior SRO staff, senior legal and compliance staff within firms, and the most prominent outside attorneys who advise firms have SEC experience. A government official commented to us in an interview that “probably over 50 percent of NASD staff are SEC alumni.” One director of a legal and compliance program in a large firm (with a background at the SEC) outlined the importance of hiring such people, even at mid-staff levels:

When I face the outside, you do have to fine-tune your behavior. . . . When you craft your message, I have to tailor it. Internally, for businesspeople not schooled in regulatory regimes, this is high subtlety. People will bring me things that I know [particular] regulators are not going to be concerned with, don’t really care about. The key is judgment and sensitivity and risk weighting of particular issues. I am probably going to offer a job to a woman who I know has got good judgment. When we worked together at the SEC years ago I got to know her. There’s another person that I hired to work with the NASD. . . . I know that he’ll be able to deal with the NASD on some key issues.

**The Environment Determining What Can Be Accomplished**

Several regulators emphasized to us in interviews that Congress, the media, and other external factors greatly expand or contract what they can accomplish at both the policy
level and in individual cases, pointing out, for example, that initiatives pushed by former SEC chair Arthur Levitt, which were politically infeasible prior to 2002, became easy to establish after Enron and other incidents (Levitt 2002; Thomas 2005). At the 2004 Compliance and Legal Division conference, a senior congressional staff member commented, “My boss said that when WorldCom broke that public lynching of board members would pass overwhelmingly.” An individual in a major securities firm conveyed the same message in a different tone, during an interview in late 2003:

> Good regulation is talking to stakeholders, coming to some reasonable agreement that preserves integrity and allows business to get done. Now, so much of regulation is by fiat, and its credibility is undermined. The environment is a lot tougher now, and bad regulations get through. We had a good relationship with the majority of regulators and had a good debate, but the relationship now is different, even with the ones that are smart and rational. Now they’re afraid to be perceived as too close to industry. They’re scared. Look at the SEC guy ... who got fired. The regulators have a gun to their heads by Congress and the press. . . . What had been a healthy relationship has become more adversarial.

However, by 2005 many critics in industry, Congress, and the media were arguing that the Sarbanes-Oxley Act and regulatory enforcement in general had gone “too far”—a view anticipated by the individual quoted immediately above, who also noted that “some of the regulations they’re putting in place just don’t make sense. You are spending an enormous amount of money to put in procedures that are not going to provide much benefit. We got them to back off of one proposal.” A panelist from the Consumer Federation of America described the title of one panel at the June 2005 NYSE regulatory conference—“Ethics and Compliance in the Securities Industry”—as “so six months ago. Now what you hear is talk of the need to restore balance to a regulatory system that has gone too far. Needless to say, this is a view that I do not share.” Regulatory standards certainly were higher in 2006 than in 2002, even if external pressures had receded to some extent; the main point is that the environment substantially influences in either direction what regulators can accomplish at any point in time.

**Firms’ Preferences and Circumstances**

Legal and compliance staff members within firms usually handle the contacts between the firm and regulatory organizations. Most of the individuals from firms who participated in the conferences and in our interviews were legal and compliance staff from the mid-management to the highest levels of the firm. They mediate between the production offices (or “business units”), which want as much discretion as possible in completing transactions, and the regulators, who want compliance with rules that usually slow transactions. Other firms’ legal problems and regulators’ scrutiny make it more likely that legal and compliance personnel will be able to get business units to comply with rules; such pressures were a pervasive theme at the conferences we observed for this research. For example, at the April 2004 Compliance and Legal Division national conference, a panelist observed, “We need to have a strong partnership with the business units and be recognized as a potent force. . . . Compliance people need to be on the management committees at the various levels of the business. . . . We need to do more than pontificate and hope for the best. . . . We have to have a high profile on the trading floor. . . . The top of the firm has to set the right tone and drive this partnership. . . . In many respects this is our time, so let’s be
sure to take advantage of it.” Another said, “A compliance officer’s job is to convey what has to be done, and test it. You need to get the word out extensively, otherwise you are hearing ‘Well, I didn’t know I had to do that . . . duh!!’ . . . To the extent that you don’t have an internal partnership, the current environment is a good opportunity to get that discussion going.” Quotations like these from the conferences could be repeated at will.

Firms know that regulators can damage their finances and reputations through enforcement proceedings (Beatty, Bunsis, and Hand 1998). What the SEC, NASD, or NYSE could do if they chose to focus on a firm underlay most of the discussions at the regulatory conferences. One of our interviewees from a large securities firm noted that “the big challenge is interpreting the new world and putting it to businesspeople in ways that they understand. When government calls and wants to meet with the CEO it gets everyone’s attention. The extraordinary has to be ordinary now” (Solomon and Squeo 2005). Similarly, an article on litigating with the NASD argued:

There is no doubt that NASD’s resources are immense compared to most of its enforcement targets. . . . It boasts a staff of about 2,200 and an annual budget of around $400 million. NASD uses those resources effectively, and the sting of its enforcement activity has become more painful recently. . . . Although it does have government-like resources, NASD is not a governmental entity, so there are many procedural safeguards not available to targets of NASD investigations that would be available to targets of SEC investigations. . . . It is thus unsurprising that targets of NASD investigations often feel dramatically overmatched. NASD is well funded, has its own procedural rules, and heads every hearing panel with one of its own. For respondents, it’s like always having to play at Yankee Stadium with Babe Ruth suited up (Rubin and Cannon 2005, 781–82).

At the 2005 Compliance and Legal Division conference, in a session on “Litigating with SROs,” one prominent outside attorney advising firms commented, “If you have a scorched earth policy, it hampers your future relations with regulators. But your client might want a pit bull. So how do you balance serving the client versus maintaining a long-term relationship with the regulator?” He added, a “key issue is the media coverage. Do you want to have multiple hits [in the media] by prolonging a case [by contesting the charges rather than settling it with the regulator]? Hopefully if you settle and get one hit, the issue might be buried beneath the fold [of the Wall Street Journal, New York Times, or other newspaper]. . . . If you develop a good relationship with [the SRO] staff, then they will come to trust you and will consider your comments in issuing the press release. They don’t want to get it wrong either.” A member of the audience added, “It’s important to have a relationship with the Wall Street Journal and other press to spin the press directly. On the other hand . . . you do not want to say things that incur the wrath of the [SRO] staff. You have to pick your battles and not get greedy. If you go line-by-line in [commenting on a draft announcement of a settlement or case], then they stop listening to you.”

Legal problems for individuals in the firm can be especially damaging. Most upper- and middle-class professionals react viscerally to the prospects of being investigated and charged by a regulatory organization, and this amplifies legal threats (Fisse and Braithwaite 1993). One study of securities firms quoted a former compliance director about the personal difficulties of being named in an action, an experience he had endured. Asked why people comply with rules even if they had a reasonable chance of getting away with violations, he replied, “It’s partly fear. No one wants to get into conflicts. It damages your reputation. It’s very time-consuming, costly. You just don’t want to deal with the
problems. You really want to stay clear of the problems. Just the process is painful. You’re not in business to make legal history” (McCaffrey and Hart 1998, 158).

Firms and individuals therefore settle the overwhelming majority of enforcement cases brought against them by the SEC and SROs. Rubin and Cannon (2005, 782) estimate that more than 96 percent of NASD disciplinary actions are settled rather than fully litigated. Of the 2,875 NYSE disciplinary cases resulting in penalties that we reviewed, in 23 percent of the cases the respondents simply did not appear before the panel and were found guilty by default, and 68 percent settled; only about 9 percent were contested through to a “guilty” decision. (Eight of 231 cases in 2003 and two of 192 cases in 2004 resulted in findings of “not guilty” and no penalties.) Firms and legal and compliance personnel focus on trying 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; we discuss these negotiations below.

NEGOTIATING COOPERATION AMONG REGULATORY ORGANIZATIONS AND FIRMS

Regulators can enforce rules more efficiently if the firms themselves investigate problems credibly and report them to regulators even beyond legal requirements, and so regulators have pushed firms to “cooperate” with them in this way. Firms fear, however, that by doing so they relinquish possibly useful legal tactics and reveal problems they are not required to reveal in exchange for uncertain concessions from regulators. Negotiating cooperation as a policy and in specific cases is central to how regulators and firms deal with each other.

Regulatory investigations require information from firms on their operations and marketing, sales practices, trading patterns, and other conduct. One way for the SEC and other regulators to get this information is to extract it through legal tools like mandatory inspections or reporting requirements. Firms and individuals, in turn, have legal rights in responding to these inquiries. They are not required to turn over information that indicates a potential regulatory problem unless regulators have asked for it or if it is not required as a part of mandatory reports. Also, communications between the firm and its individuals and their attorneys may fall under the attorney-client privilege intended to preserve the confidentiality and thus candor of their discussions, and regulators are not entitled legally to such communications. While public and private regulators have substantial legal powers, rules require regulators to respect notions of fairness and legal due process when exercising these powers; firms and individuals must comply with legal obligations but not with regulatory requests that mainly further administrative efficiency. This makes discovery and investigation of regulatory problems more expensive and difficult, but—the argument goes—that is a reasonable price for protecting firms’ and individuals’ rights in dealing with powerful regulatory organizations.

Alternatively, regulators can get information necessary for their investigations and enforcement by firms’ providing it voluntarily as part of effective internal legal and compliance programs and “good corporate citizenship.” Regulators usually have wide discretion in the cases they bring and the penalties they impose (Cutler 2004). They can reward “cooperating” firms by lessening penalties in ensuing enforcement actions or even not charging the firm at all. In 2001 the SEC released a “Statement on the Relationship of Cooperation to Agency Enforcement Decisions.” It explained that, while settling a case with the controller of a subsidiary of Seaboard Corporation, it was not charging Seaboard itself because the corporation investigated, corrected, and reported the problem promptly.
to the SEC and cooperated fully in the subsequent investigation (U.S. Securities and Exchange Commission 2001). The SEC wrote, “When businesses seek out, self-report and rectify illegal conduct, and otherwise cooperate with Commission staff, large expenditures of government and shareholder resources can be avoided and investors can benefit more promptly.” The SEC said that when firms have active self-policing programs in place prior to the incident, quickly and effectively report the misconduct to authorities, take steps to prevent the problem in the future, and cooperate fully with the SEC in its investigation beyond legal requirements, the SEC would determine “whether, and how much, to credit self-policing, self-reporting, remediation and cooperation—from the extraordinary step of taking no enforcement action to bringing reduced charges, seeking lighter sanctions, or including mitigating language in documents we use to announce and resolve enforcement actions.” It identified thirteen factors—the nature of the misconduct, the firm’s history, management behavior, and so forth—it would consider in answering those questions, pointing out that “we do not limit ourselves to the criteria we discuss below. By definition, enforcement judgments are just that—judgments. Our failure to mention a specific criterion in one context does not preclude us from relying on that criterion in another. Further, the fact that a company has satisfied all the criteria we list below will not foreclose us from bringing enforcement proceedings that we believe are necessary or appropriate, for the benefit of investors.” The SEC cited the Seaboard case, or evidently followed it, in not filing charges or mitigating penalties in several cases since 2001 (Diamond 2004; Gourcevitch and Taube 2004).

Firms argue, however, that requests for cooperation have evolved into expectations of cooperation, including expectations that they will relinquish particular legal options, and that not to cooperate beyond legal requirements invites regulatory punishment. Since 2002, the SEC has charged several firms with impeding investigations through withholding of information and failure to comply with negotiated agreements; firms, in response, maintain that simply defending themselves legally but aggressively invites regulators to tack “failure to cooperate” charges onto other charges (Diamond 2004, 1070). SEC accusations that a firm is trying actively to impede an investigation and firms’ fears that regulatory organizations coerce cooperation are the extreme possibilities. Normally, the climate is one in which regulatory organizations want to see firms voluntarily cooperating “in good faith” without having to tell firms in advance what concessions they will receive, and firms worry about giving up information and legal options voluntarily without a clear sense of the concessions from regulators. The following two exchanges illustrate this debate between regulators and firms. The first, involving two members of an SRO’s enforcement staff and a large firm’s director of compliance, occurred at the 2005 NYSE conference on regulation:

Compliance Director: [If you do not deliver information to regulators that you promised] you can lose in one case a year’s worth of credibility with a judge or regulators.

SRO Enforcement Staff 1: If you find a problem, tell us right away. If it’s a systemic problem, tell us immediately. We won’t give you credit for it, but it may reduce any eventual penalty.

Compliance Director: You’d think that when you’re asked to do something, it would be nice to get credit for it. . . . If a problem comes up, don’t wait until the last minute to ask for more time. Not everyone at the [SRO] is unreasonable [laughter]. You can get a nice dialogue going.

SRO Enforcement Staff 2: We like nice dialogues.
**SRO Enforcement Staff 1:** We’re going to ask only for what we need. The burden for us in reviewing e-mails is as great as it is for you to produce them. . . . If we have not put a request in the right way—like the [computer] server type—tell us. Don’t turn this into an Easter egg hunt because that’s going to restrict our flexibility in the future in terms of what we give you in terms of credit for working with us. The regulated doesn’t determine the scope, the regulator does, but we will work with you on this. If you’re aware of a problem, bring it to our attention. We can’t give you a pass, but if we find it out, it will be worse. We can find this out in the most innocuous ways, and you are a lot better off coming forward ahead of time before we find out about something.

The following exchange took place at a plenary session of the SIA’s Compliance and Legal Division conference in April 2005 and involved the senior directors of enforcement at the SEC, NASD, and NYSE and two prominent individuals from a securities firm and outside law firm:

**Firm:** There has been a transformation of cooperation. Previously it was something to be rewarded, not a stick to punish people who do not cooperate. But the [Securities and Exchange Act] does not allow penalties for lack of cooperation. . . . When we do get a ding and have cooperated, it’s nice to be recognized.

**SEC Enforcement Director:** Last year we recognized cooperation as a factor in fifteen cases. . . . Also, [section] 17A [of the Securities Exchange Act] on books and records requires prompt production to Commission when requested, so there is some statutory authority [for penalties for lack of cooperation]. But, more broadly, the penalty framework is very flexible . . . .

**SRO Enforcement Official 1:** I’m not sure everyone does want to be a cooperator. Statutory duty compliance is not cooperation. Abiding by rules is not cooperation. Cooperation is coming in, giving facts, not legal conclusions; you help us conclude our investigation more quickly so we can turn our resources elsewhere. . . . When we discover a violation, and the firm says that they resolved the issue internally and fined the employee, but didn’t tell us about it—that’s not cooperation. You need to bring it to our attention.

**SRO Enforcement Official 2:** There is a need to define cooperation. The Piper Jaffray case in January is a good example of how it should be done. We acknowledged [Piper Jaffray’s cooperation] in our press release.

**Attorney:** Public identification as a cooperator is important, but a more important thing is the level of penalties. Do you cut [a fine] down from $20 million to $500,000?

**SRO Enforcement Official 2:** Do you really want us to say that this is a $50 million violation, but we’re cutting it down to $500,000 because of cooperation?

**Attorney:** No, but I want it reflected in the sanctions.

Regulators thus indicate to firms that they will receive unspecified benefits if they cooperate and will suffer if they do not; however, regulators will be overwhelmed if firms stop settling cases at such high rates and force regulators to rely primarily on their legal powers. For their part, firms want to stay on good terms with regulators because regulators have wide latitude in how they handle violations and penalties, but they also want to deal with regulators from as strong a position as they can; this means agreeing to some requests
and pushing back on others. Regulators and firms therefore are interdependent, have multiple incentives in play, and have to negotiate outcomes at all levels of the regulatory process. The next section describes the social context in which these discussions take place.

**SOCIAL DYNAMICS AND DEALINGS AMONG REGULATORS AND FIRMS**

How regulators, firms, and the individuals involved deal with each other depends heavily on their mutual familiarity and the levels of trust between them. The exchanges among them that we observed at the conferences constantly referred to the importance of “dialogue” and “relationships” in shaping the field’s work.

“Social capital” refers to the ability to mediate among and connect parties in useful ways because of prior experience and resulting social relationships (Burt 1992, 8–9). One study asked an individual with extensive experience in both government and industry why people involved in financial regulation seemed so familiar with each other. He responded, “Maybe it’s that in the financial arena, the nature of interaction between the official legal and private types is day by day. You cultivate a familiarity [that is not common]. It’s day by day, hour by hour. It’s also true that the incidence of financial disturbance has been of sufficient frequency and magnitude that it leads to interaction” (Faerman, McCaffrey, and Van Slyke 2001, 378). One of the individuals we interviewed in December 2003 said, “Wall Street is a small place. Everyone knows everyone else. You know people from different contexts, and people don’t spend a career in one shop. There is a great amount of movement around. This was helped along by consolidation. As firms went out of business or combined, people moved around. . . . Outside law firms take in a lot of the lawyers when firms consolidate, though not the compliance people. . . . People at the SEC move to industry. There is a very significant informal network.”

Regulators and firms clearly clash on issues. However, regulators, market participants, and attorneys, when confronted with hard questions at the conferences, consistently stressed the importance of “calling us if you have a problem or a question,” “dialogue”—the frequency with which the word is used in the quotations below is not exaggerated—or other appeals to ongoing working relationships. The interview comment from the securities firm executive, noted earlier, that “good regulation is talking to stakeholders, coming to some reasonable agreement that preserves integrity and allows business to get done” comes pretty close to describing what participants presented as the ideal state of affairs.

The following exchange at the 2005 NYSE conference, involving an industry attorney who was chairing the session, two SRO staff members—one from the inspection division and the other from enforcement—and two legal and compliance staff from securities firms, conveys how these social dynamics pervade how regulators and firms deal with each other during inspections. We cite this exchange at length because of how it indicates the give-and-take over the routines of inspections and enforcement, but similar comments were common at all the conferences we observed for this research.

**Attorney:** What if you [the firm] find a potential violation [in a regulatory examination before the examiner does]? When should you disclose this?

**Firm 1:** In some cases you have the luxury of having an examiner from prior exams that you have developed a level of trust with. But if you don’t have a sense of how the person would react, I would be reluctant to have an issue pulled away from me until I was sure I knew what happened.
**Attorney:** Yes, but consultation and trust is a two-way street. Do you have the same person at the firm dealing with an examiner [over multiple exams]?

**SRO Inspection Staff:** The relationship is key, and you need to develop this throughout the year, even outside the examination time. [Discusses an incident in which a firm reported a problem to the SEC that it discovered during the SRO’s exam without informing the SRO of the discovery. The SRO found out about the disclosure to the SEC after it was made, with the staff member concluding, “We did not appreciate this.”] Regulators want to be informed. People have to have the information and insights as they become known. People feel slighted if they have a sense that a firm is holding back information.

**Firm 1:** Actually, I can see how a firm in that case felt it was doing the right thing in telling the SEC. But the gap was that the examination team was not informed. Someone felt excluded from the information . . .

**Firm 2:** We have a constant sense of Groundhog Day [referring to the film in which the main character repeatedly wakes up to the same day with no other character remembering what had happened previously]; we’re always dealing with a new group of people [from regulators in examinations]. This does seem to be getting addressed. It’s so important to get a dialogue going during the exam. If there is a potentially serious violation, you should raise it during the exam. This can cut months off the investigation process.

**SRO Enforcement Staff:** There really has to be one voice at the firm, one point of contact so we know who to talk to.

**Firm 2:** We do appreciate the changes we see happening with [the examination staff]. But the whole tone of dialogue with [the SRO] changes from [the examination staff] to [the enforcement staff]. We often find that we’ve handled the problem internally, but we can’t get it out of the enforcement machine.

**SRO Enforcement Staff:** Well, the dialogue changes when firms talk to different people. When they talk to [the examination staff] it’s “We admit the problem and we’ve fixed it.” When it goes to enforcement, it’s “We don’t admit it.”

**Firm 2:** Is that inconsistent? [Laughter]. We know that there are cultural differences between [examination staff] versus enforcement. But can’t there be some narrowing of the differences? . . .

**Attorney:** It’s important to try to take care of problems right away. You’re going to have a better case if you explain human errors.

**SRO Enforcement Staff:** A good example is firms just sending on a box of documents without any labels when we ask for the documents. You have to label what’s in the box. But often firms don’t take it seriously and have a paralegal handle it, who just puts the documents in a box, and we have to sort through it.

**Firm 1:** Many problems stem from an interpretation of what’s happened. Not labeling documents is a mistake rather than a matter of a firm not taking it seriously.

**SRO Enforcement Staff:** Well, then it’s important to have a dialogue on that.

**Firm 2:** If you feel a firm is not cooperating then escalate it right away before you get an overall impression of the firm. Tell us what you see as the issue . . .
SRO Enforcement Staff: In negotiations and settlements the best practice is just to do it in good faith.

Attorney: Oftentimes there’s a sense that we’ve fixed the problem. But now I have to go back to the business folks and explain why we have a fine.

SRO Enforcement Staff: But remember that we are overseen by the SEC. If we don’t take some action, we’d be questioned. If all you had to do was fix a problem, there would be no incentives to improve. We take a lot of things into consideration in determining a penalty.

Attorney: Those are good points: First, there is SEC oversight of SROs. Second, firms have to articulate mitigating factors and any changes that they made. The more you do, the better off you are. It’s important to sensitize SRO staff and work more towards a collaborative effort that you might not like but that you can respect.

SRO Enforcement Staff: When we still file charges you have to remember that we can’t just say, “You’re a nice guy, you’ve fixed it, let’s move on . . . .”

Question from Audience: What if there is a good faith disagreement over rule interpretation between the firm and the exam staff? How do you raise this?

SRO Inspection Staff: By all means escalate it. We don’t have a problem with that. We want to get this right. Feel free to disagree with us. That’s the importance of dialogue. We want to get the findings right.

Comment from a Firm in the Audience: People say that they do get a sense that the exam staff is open to critiques of their rule interpretation. But if the exam report does not indicate a disagreement that the firm made, then make sure that you raise this with [the enforcement staff].

So, regulators who want their work to go smoothly depend on firms cooperating and settling enforcement cases before costly formal litigation (recall that over 90 percent of cases are settled). 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.” Hiring practices reflect this system and reinforce it; being respected by the other side is a major career advantage. Regulators and firms negotiate in a very thick social system, and understanding how decisions get made requires understanding that system (Haas 1992; Posner 2000).

BENEFITS AND LIABILITIES OF STRONG SOCIAL TIES

As discussed earlier in this article, a system with such strong ties and working relationships has advantages and potential risks.

Potential Benefits of Strong Ties

On the benefits side, the higher levels of cooperation possible in such a system make it easier to resolve difficult problems without costly formal litigation (Kagan 2001). Regular communication helps to narrow the gaps in knowledge between industry and regulators.
In the conferences, private and public regulators referred repeatedly to bringing individuals from industry into their organizations to brief regulatory staff on emerging developments. In a more controversial move, the SEC asked large firms in 2004 to assess potential conflicts of interest within their firms and the industry as a whole—called “directed self-assessment”—and then report findings voluntarily to the SEC as a way to identify problems in advance (Richards 2004). The following exchange at the 2005 SIA national conference among a senior legal executive from a securities firm, a prominent industry attorney, the SEC enforcement director, and an SRO enforcement director indicates the industry’s fear that the SEC, and in turn the SROs, were asking firms to report potential violations before any had occurred but also how regulators and firms reached an accommodation.

Firm: A major issue in recent years is the rise of directed self-assessment. After [SEC director of enforcement] Steve Cutler’s speech on this, there was an initial sense that this could be taken with a “gotcha” approach, and so there was a lot of apprehension. But Steve has gotten a lot of credibility from the way it’s been handled, and overall this has been a positive development. But in 2004 things took a disturbing turn with a request from the SEC and then NASD and NYSE for self-assessments in specific areas. Firms had to do a report detailing “potentially deceptive and/or dishonest practices” in [specific] areas [the resulting fear being that firms were being asked to confess potential wrongdoing before it actually occurred].

SEC Enforcement Director: Yeah, I guess the letter we sent [to firms] concerning [one particular practice] could have been edited. We need to be more careful about soliciting legal conclusions rather than just factual matters. We do not want to have a chilling effect. On the other hand, we could have sent out sixty interrogatories asking for the information, but wanted to try something new. Something like this leverages our resources . . . The challenge is to do it in such a way that we don’t penalize firms who do a really good job of their self-assessments, and that we not reward those who do a shoddy job. This is matter of kicking the tires; it’s an experiment.

Firm: Why did you do this?

SEC Enforcement Director: There was a sense that there was an issue but that we could not tie it to a particular firm.

SRO Enforcement Director: We used it in one area . . . where the issue wasn’t one of fraud but an operational issue that we were concerned about. We had seen the problem at some firms and wanted to see if it was a general problem . . .

Industry Attorney: The approach of “Tell us any violation you found” is the problematic part . . . OCIE [the SEC’s Office of Compliance Inspections and Examinations] should not have an enforcement function through self-assessment . . .

SEC Enforcement Director: Look, we met with firms and said, “OK, if you have a problem with this, let’s do it our regular way,” and firms said “No, no, no—we’ll do it this way.” So there’s some schizophrenia on your side of the table.

Individuals from firms commented regularly that the self-assessment process was on balance a useful way to communicate with regulators and elevate consciousness of legal and compliance obligations within firms. At the national conference panel in 2005, one compliance director of a large firm said, “When we told our business units of the SEC
request [for self-assessment of conflicts of interest] they said, ‘We don’t have conflicts’ [laughter]. But, in fact, they are taking it seriously.’ Another panelist immediately added, “Having business folks with us in making the presentations to the SEC helped a lot [because it showed the SEC that we were serious about the process]. We are encouraging business involvement in internal and external compliance presentations and work. Compliance is not just compliance’s job.” The following passage written in 1995 by two private attorneys who were working in securities regulation (both with experience at the SEC) summarizes the benefits of these close ties:

> In the past few years, the [SEC] staff has undertaken several large-scale reviews of various issues confronting the industry. In each instance, Wall Street has either cooperated extensively with the staff in its fact-finding or collaborated with the staff on the issuance of a report setting forth the views of the Commission and the industry. These efforts have led, as well, to changes in the practices engaged in by the industry and have served as alternatives to the enforcement process. As part of this process, the attorneys representing both regulated entities (such as securities firms, investment companies, investment advisors) and public companies have developed a unique relationship with the enforcement staff. Frequent interaction between senior members of the Enforcement Division and defense counsel (both in-house and outside counsel) at securities programs and conferences, while at times barbed, is often enlightening and instructive for all participants in the process. The bar and the staff have also worked closely on various projects affecting the Enforcement Division’s work. Moreover, many members of the securities bar once worked at the Commission and often attained senior positions within the agency. As a result of that experience, securities practitioners afford the staff an enormous amount of respect, appreciate the difficulties of the staff’s job, and treat the enforcement process seriously (Flannery and Indek 1995, 23–24).

**Potential Liabilities of Strong Social Ties**

Strong ties encouraging useful cooperation among insiders also tend to restrict the flow of information and effective criticism from outsiders, leading to accommodations among insiders that eventually can cause problems (Brass et al. 2004; Gargiulo and Benassi 2000; Rasmussen 1997; Uzzi 1997; Vaughan 1996). Securities regulation demonstrates this possibility; for example, the SEC, NASD, and NYSE acted against conflicts of interest in investment banking and in mutual funds, two notable recent problems, only after outsiders did so.

In 2003 regulators, prosecutors, and ten large securities firms settled charges, at a cost of $1.4 billion, that the firms had encouraged their investment analysts to publicly exaggerate corporations’ investment value, misleading investors, in order to win the corporations’ investment banking business. For several years this was an open secret in the industry, and the press and earlier congressional hearings had focused on it. Participants were aware of its ethical implications but generally had come to live with it as a normal part of business (Kessler 2003; U.S. House of Representatives Committee on Financial Services 2001). A memorandum within Lehman Brothers in 1999, reproduced in the related NYSE disciplinary case available on the NYSE website, articulated a widely accepted “new paradigm” for “synergy” between analysts and investment banking.
The August 5 Memorandum also set forth a “new paradigm” for Lehman’s investment banking relationships, stating:

the analyst is THE key driver of the firm relationship with its corporate client base. Analysts need to accept responsibility and use it to expand the franchise and DRIVE PROFITABILITY EVERY DAY BUT IN A WAY THAT IS CONSISTENT WITH BUILDING A LONG-TERM FRANCHISE. (Emphasis in original).

The August 5 Memorandum emphasized the research analyst’s role in identifying potential banking business for Lehman stating: “global research must drive the banking targeting efforts, consistent with the ‘new paradigm.’” The August 5 Memorandum stated further: “to ensure we have proper recognition of analysts’ impact on banking, we have to closely track every dollar of IBD [investment banking] revenue (equity, M&A, and debt) by analyst” (New York Stock Exchange 2003, 5–6; italics added by the authors, other emphases in the original).

One e-mail exchange between an analyst and a large institutional investor about an excessively favorable rating for a firm described the situation:

The institutional investor and the analyst discussed the effect of the conflict of interest on the analyst’s research in the following exchange:

Institutional Investor: I understand—business is business. But I feel bad for those naïve investors who assume that sell-side analysts are objective! I wish some buy-side institutions would get together to establish an independent equity research consortium with analysts paid for on a subscription basis or something . . .

Analyst: well, ratings and price targets are fairly meaningless anyway, buy-side [large investors] generally ignores, commentary is what matters and I’ll be [more negative about the company] in my comments . . . but, yes, the “little guy” who isn’t smart about the nuances may get misled, such is the nature of my business (New York Stock Exchange 2003, 15; italics added by the authors).

Most of the time firms follow clear rules that are usually enforced. Absent clear rules, as in the investment banking case above, ambiguous principles such as “just and equitable principles of trade” compete with short-term imperatives to complete transactions, and firms tend to err on the side of doing deals. Rules did not clearly prohibit the investment analyst/investment banker collaboration, and so it could emerge as a “new paradigm” of attracting investment banking revenue, eventually generating ethical and legal problems. New York attorney general Eliot Spitzer, who initiated the investment analyst cases, acknowledged that they stemmed from a “commonly accepted—indeed embraced—business model that was flawed” rather than violations of clear rules (Hill 2004) and that this “in a way undercut the validity of subsequent criminal cases. There is something problematic about saying, ‘We’re changing the rules, but because you’re playing by the old rules, we’re sending you to jail.’ The rules should have been changed before by other enforcement entities, but that’s a separate issue” (Business Week 2003, 129).

Spitzer’s investigation led the investment analyst cases in 2002. Then, in 2003, Spitzer and Massachusetts secretary of the commonwealth William Galvin targeted practices in mutual fund sales and marketing, most of which were technically legal but questionable and/or deceptive; again, organizations outside the mainstream of
securities regulation instigated cases against practices that insiders had come to tolerate as a normal underside of business (U.S. Government Accountability Office 2005a; U.S. House of Representatives, Committee on Financial Services 2003b).

In the 1990s rising stock indices suppressed any tendencies for new regulatory initiatives that might “unsettle” markets; the discrepancy in SEC resources and workload was especially large in the late 1990s (Khademian 2002; Seligman 2003). Without strong external pressures for assertive regulation, the stable working relationships that facilitate communication and settlements among regulators and industry also contributed to regulators’ accommodation of questionable industry practices in this period. One article quoted a twelve-year staffer as saying, “We don’t have career civil servants writing the rules anymore—Wall Street writes our rules... Instead of being the investor’s advocate, we’re the investment banker’s advocate. We fell asleep on the job, and we’re still asleep” (Institutional Investor 2003, 34). In the same article, then-SEC chair William Donaldson, who prior to his appointment in 2003 had an extensive industry background, made a somewhat similar point less harshly: “I’ve always admired the SEC, even though we had our share of battles over the years. It has always been very fair and very professional, and it continues to have that reputation. But the SEC has been deluged with work on an inadequate budget. That leaves very little time to go on the offensive—anticipate problems and prevent them from happening. Overall, management of the SEC hasn’t been that high a priority, given that there’s hardly time to do anything other than process the business... We need more agility” (Institutional Investor 2003, 36).

State regulation, on the other hand, is outside the mainstream of securities regulation. States regulate firms and individuals conducting securities business within their borders, and did so well before the federal government, but the SEC’s establishment shifted regulation’s center of gravity to Washington in the 1930s. States are not as integrated into regulation’s formal and informal networks as the SEC, SROs, and firms; one indicator of this is how states are far less prominent on panels at industry conferences on securities regulation.

Those who argue for a dominant federal role maintain that diverse state politics can produce unpredictable and erratic decisions that could undermine a national and global industry and so states should not play a central policymaking role (McCaffrey and Hart 1998, 44–46). One of our interviewees in a securities firm commented in November 2003 that:

> The real core of the [regulatory] system is the SEC, NASD, and NYSE... There is a set of informal networks of people who know each other and who have built up credibility. You don’t want people parachuting in and upsetting the apple cart. Like Eliot Spitzer and [Massachusetts secretary of the commonwealth] William Galvin. Direct voters [who elect state officials] aren’t thinking of the structure of capital flows and equity in the same way that

2 The national conference of the Compliance and Legal Division of the Securities Industry Association in Florida in April 2003 featured thirteen panelists from the SEC and three other federal organizations, ten from the NYSE, thirteen from the NASD, and six from the states. The Fall Compliance Seminar of the same organization in November 2003 in New York City scheduled one from the SEC, five from the NYSE, four from the NASD, and none from the states. The national conference in Phoenix in March 2004 featured eighteen panelists from the SEC and two other federal organizations, ten from the NYSE, twelve from the NASD, and six from the states. The 2005 national conference in California had seventeen from the SEC and three other federal organizations, sixteen from the NASD, twelve from the NYSE, and four from the states. The 2006 conference in Florida had sixteen from the SEC, twenty-one from the NASD, sixteen from the NYSE, and five from the states.
Ed Kwalwasser [then executive vice president of NYSE regulation] or Paul Roye [former director of the division of investment management at the SEC] are thinking of them. When you pull the system off balance you will wind up with a system with skewed results . . . . People within the network understand capital markets and liquidity. States don’t.

States respond that they target violations and issues that other regulators miss or choose not to pursue for one reason or another, pushing regulation to be more effective than it would be otherwise. Spitzer, Galvin, and other state officials acknowledged their disruptions with pride, arguing that the balance into which the SEC, NYSE, NASD, and firms had settled allowed serious problems to persist. In an interview with two staff members of a related congressional committee in November 2003, one observed, “They’re [the SEC] constantly talking to [mutual] fund companies. Where do you draw the line? You want a good working relationship, but you can’t be captured.” The person’s colleague quickly added, the SEC “has been pathetic in enforcement” in the mutual fund area.

Individuals within the central regulatory network acknowledged these tendencies in our interviews and at the conferences. One attorney with extensive experience in representing securities firms and as a regulator observed in an interview in December 2003 that “this is probably why you have a dumbing down of industry rules by consensus. The comment you always hear is ‘so and so does it.’ Everyone takes comfort from the fact that everyone does it. Meanwhile the SEC and NYSE, even if they might be generally aware of something, may come to accept it in the absence of a major breakdown or scandal. There is a comfort and confidence from what is going on the Street, sometimes a false comfort.”

As a senior regulator noted to us in October 2004, “We learned a lesson from the conflicts of interest case. We felt very burned by Spitzer. We need to figure it out early and get it early when there is an emerging problem.” At the 2005 SIA national conference, the director of enforcement at the SEC reflected on why regulators and firms had not challenged this problem, linking it the effort to get firms to do assess their potential conflicts of interest: “You can be completely comfortable with practices, and they can be legal, but things evolved in a sufficiently slow way in a direction that become unmoored from the original situation so people did not respond to the change. . . . The purpose of [directed self-assessment] analysis is to think about things that we all get comfortable with because we’re so close to them. That’s the purpose of conflict review. Why is it overseen by Enforcement? So you’ll take it seriously. If we see the same type of case in five years, we will have failed as a program.”

Such reviews would need to counter tendencies found in cohesive social networks more generally (Vaughan 1999). It is difficult to steer firms away from practices when firms defend them as aggressive but legitimate business models, the models have not yet produced legal problems, and regulators and firms work in an interdependent social system in which dialogue is a main way of resolving issues. Resulting crises produce new procedures to mitigate these tendencies, but getting the procedures to operate reliably when the crises and external pressures recede is the challenge.

As noted earlier in this article, ideally regulation takes advantage of public and private insiders’ expertise and avoids paralyzing conflicts; strong external oversight helps keep insiders from slipping into objectionable accommodations and preserves the credibility of the regulatory system; and a resulting track record of effective regulation gives public and private insiders the legitimacy to deal with complex issues in appropriately subtle ways.
This achieves what Peter Evans (1995) has called “embedded autonomy” and what Stephen Breyer (1993) has described as a virtuous circle of effective regulation. If cohesive systems in general come to gradually accept serious performance problems, then it is important to maintain the strength of those institutions most likely to punch through the boundaries around the system’s core actors to object—in this area, state regulators, the media, Congress, and private attorneys who represent investors rather than firms. Those on the inside of the system, objecting to the disruptions outsiders can cause, regularly (but not unanimously) propose legislation restricting states’ regulatory powers and opportunities for private litigation against firms (NERA Economic Consulting 2003; U.S. House of Representatives, Committee on Financial Services 2003a). These changes arguably would threaten backup controls and would be advisable only when there is overwhelming evidence of net benefits from the restrictions, and such evidence rarely exists.

**IMPLICATIONS AND CONCLUSION**

Early research on government regulation evaluated its impact mainly by studying how inspections affected firms, but analysts now emphasize that compliance is a much more complex process than these early studies implied. Bardach and Kagan (1982) were among the first to examine closely dealings between inspectors and firms, criticizing blunt regulatory controls as unsuitable and noting that the most skilled inspectors tried to avoid using them unless absolutely necessary. Recent research has demonstrated that firms comply more because of general apprehensions about penalties and other social sanctions than rational calculations of immediate consequences of enforcement, and laws and rules stimulate broader social and political changes to which firms react in diverse ways (Gunningham, Thornton, and Kagan 2005; Kagan, Thornton, and Gunningham 2003; Thornton, Gunningham, and Kagan 2005). Peter May has shown how firms respond to regulation based both on the “negative” motivations of avoiding fines and other penalties and the “affirmative” motivations of accepting the legitimacy and purposes of the rules (May 2004, 2005). And, regulation can have spillover effects within the firms, stimulating the development of legal and compliance work within firms that reaches unregulated areas through various channels of organizational influence. Works such as these probed behavioral dynamics in the “black box” of firms and showed how they differed substantially from those predicted by models based almost entirely on enforcement deterrence (Mendeloff and Gray 2005; Simpson 2002).

How norms, group affiliations, and other social factors substantially drive behavior also was the issue in the early debate between economists and sociologists over how well behaviorally simplified models explained economic action. That debate is less contentious now because both fields grant the basic idea and the remaining differences between them have narrowed (Camerer, Lowenstein, and Rabin 2004; Smelser and Swedberg 2005; Sunstein 2000; Swedberg 1990). Here, as in the regulatory literature, when researchers examined directly what people were doing, they found social factors driving behaviors much more than implied by earlier economic perspectives on markets (Uzzi 1997).

As noted at the outset of this article, newer forms of regulation, and public management and policy more generally, require closer dealings among organizations in the public

---

3 The SEC generally has seen private litigation as complementing its enforcement program and has opposed restrictions on it (Seligman 2003).
and private sectors (Salomon 2002). Studying how regulators and firms engage each other in such networks is necessary for both research and education in public management. Having done the research for this article, we do not believe that one can really understand how securities regulation is practiced without immersing oneself in the culture of the field. Social ties, the circulation of professionals within the inside community of regulators and firms, the steady appeals to “dialogue,” the importance of the norm of being “reasonable,” and the other patterns discussed here are absolutely fundamental to how work is accomplished in the area. We suspect—but obviously cannot say on the basis of this research alone—that someone examining other important regulated sectors in the same way would reach similar conclusions (Rees 1994, 1997). This also suggests that education of public managers—and certainly of those looking to move into business regulation—needs to soften the boundaries between the study of public and private management because people increasingly operate in a world in which effective work requires familiarity with both.

REFERENCES


Hawthorne, Fran. 2005. Inside the FDA: The business and politics behind the drugs we take and the food we eat. New York: John Wiley.


