
YALE LAW & POLICY REVIEW

Backstop Ambiguity: A Proposal for Balancing Specificity and Ambiguity in Financial Regulation

Julian J. Z. Polaris*

INTRODUCTION.....	232
I. A DECLINING EMPHASIS ON CORPORATE REPUTATION.....	235
A. <i>The Reputation Model</i>	235
B. <i>“The Death of Corporate Reputation”</i>	236
II. A MISPLACED EMPHASIS ON LEGAL CERTAINTY.....	237
A. <i>The Bias in Favor of Legal Certainty</i>	237
B. <i>The Impossibility of Certainty in Effective Financial Regulation</i>	239
III. PROPOSAL: BRIGHT-LINE RULES AND “BACKSTOP AMBIGUITY”	241
A. <i>Proposal Overview</i>	241
1. What Backstop Ambiguity Is.....	241
2. What Backstop Ambiguity Is Not.....	243
B. <i>A Theoretical Assessment of Backstop Ambiguity</i>	245
1. The Advantages of Backstop Ambiguity.....	245
2. The Risks of Backstop Ambiguity.....	247
C. <i>Examples of Backstop Ambiguity</i>	249
1. Tender Offers: Specific Rules, Vague Trigger.....	249
2. Insider Trading: Vague Standards, Vague Norms.....	251
IV. DESIGNING A SYSTEM WITH BACKSTOP AMBIGUITY	252
A. <i>When to Use What: Rules vs. Standards</i>	253
1. The Identity of the Potential Victim.....	253
2. The Magnitude of the Potential Harms	254
B. <i>Regulatory Considerations for a Backstop Ambiguity Regime</i>	256
1. Magnitude of Sanctions.....	256
2. Who to Sue? Individual vs. Institutional Defendants.....	258
3. Consistency of Enforcement	259
4. Keeping Up with the Times	260

* Yale Law School, J.D. expected 2015. Thanks to Professor John Morley for helpful comments on an early draft, and to the wonderful editors at the *Yale Law & Policy Review* for their careful reading and thoughtful suggestions.

CONCLUSION: THE RETURN OF REPUTATION?	261
---	-----

INTRODUCTION

The Securities and Exchange Commission (SEC) has been very busy for the last few years. In the wake of the 2007-2008 financial crisis, the agency scaled up enforcement efforts by increasing the number of individual enforcement actions,¹ requesting that Congress authorize larger civil penalties than are currently permitted,² and securing some of the largest settlements in the agency's history.³ The specific transactions targeted by the SEC are feared to be part of a broader trend in the financial industry toward behavior that prioritizes profit over integrity, potentially imperiling individual market actors and overall economic stability.⁴

Nonetheless, some commentators have criticized the SEC's increasingly aggressive approach,⁵ particularly in light of the longstanding critique that the

1. See *Year-by-Year SEC Enforcement Statistics*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/news/newsroom/images/enfstats.pdf> (last visited Jan. 10, 2014).
2. Peter J. Henning, *S.E.C. Seeks More Power, but Does It Need It?*, N.Y. TIMES DEALBOOK (Dec. 5, 2011, 4:05 PM), <http://dealbook.nytimes.com/2011/12/05/s-e-c-seeks-more-power-but-does-it-need-it> (explaining that SEC Chairwoman Mary L. Schapiro sent a letter to a Senate banking subcommittee "describing the S.E.C.'s desire to impose greater monetary sanctions for securities violations and to allow it to punish repeat offenders").
3. See, e.g., DealBook, *Goldman Settles With S.E.C. for \$550 Million*, N.Y. TIMES DEALBOOK (Jul. 15, 2010, 4:17 PM), <http://dealbook.nytimes.com/2010/07/15/goldman-to-settle-with-s-e-c-for-550-million> (noting that the settlement is the "largest penalty ever assessed against a financial services firm") (quoting Robert Khuzami, SEC Director of Enforcement); Maureen Farrell, *J.P. Morgan Adds \$2.6 Billion to Its \$25 Billion Plus Tally of Recent Settlements*, WALL ST. J. MONEYBEAT (Jan. 7, 2014, 11:24 AM), <http://blogs.wsj.com/moneybeat/2014/01/07/j-p-morgan-adds-1-7-billion-to-its-25-billion-plus-tally-of-recent-settlements> (noting that "J.P. Morgan has set records with at least two of its settlements").
4. See generally JONATHAN R. MACEY, *THE DEATH OF CORPORATE REPUTATION: HOW INTEGRITY HAS BEEN DESTROYED ON WALL STREET* (2013).
5. See, e.g., David M. Becker, *What More Can Be Done to Deter Violations of the Federal Securities Laws?*, 90 TEX. L. REV. 1849, 1849 (2012) (noting that criticism of the SEC "has focused on the severity of sanctions the SEC obtains in its settlements with wrongdoers"); see also MACEY, *supra* note 4, at 235-36 ("Time and time again, the SEC has employed a litigation strategy that involves suing all industry participants," which "make[s] it difficult for investors and other members of the general public to distinguish bad guys from good guys"). But see *A Fine Mess: SEC Aims to Raise Penalties Amid Criticism of Settlements*, INVESTMENTNEWS (Nov. 29, 2011, 3:57 PM), <http://www.investmentnews.com/article/20111129/FREE/111129892> (noting public "criticism that the agency hasn't done enough to punish misdeeds tied to the credit crisis").

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

agency does not provide clear definitions of potentially actionable behavior. Indeed, the record 2013 settlement with Goldman Sachs arose out of the SEC's expansive prohibitions on fraud,⁶ and the Department of Justice (DOJ) has capitalized on similarly worded laws to bring finance-related criminal charges.⁷ Conventional wisdom holds that legal certainty and predictability promote efficiency and fairness,⁸ but former SEC General Counsel David Becker admits that "there is an aversion among Commission staff to specifying precisely where the line is between legal and illegal conduct."⁹ Becker's is one of many voices calling for greater clarity on the boundaries of permitted conduct.¹⁰

This Note stakes out a middle ground, arguing that careful reliance on definitional ambiguity can play an important role in regulating an industry that seems to have lost its moral compass. Regulators should delineate specific violations where it is possible to do so, but should retain catch-all provisions stated in general terms. This "backstop ambiguity" provides essential flexibility and adaptability in enforcement, thereby discouraging attempts to exploit loopholes in bright-line rules.

This is not to suggest that government action should be wholly unpredictable; arbitrary enforcement vitiates deterrence and violates the basic principles inherent in the rule of law. Rather, this Note advocates for a guaranteed gray zone around a set of specifically enumerated violations in any particular area of regulation. If regulated entities know that literal adherence to the text of rules

-
6. See, e.g., DealBook, *supra* note 3.
 7. See William L. Anderson, *Federal Crimes and the Destruction of Law*, REG., Winter 2009-2010, at 10 (criticizing the DOJ's increasing reliance on racketeering and fraud charges in recent decades).
 8. See Diane Lourdes Dick, *Confronting the Certainty Imperative in Corporate Finance Jurisprudence*, 2011 UTAH L. REV. 1461, 1466 (noting the pervasive view that "stable financial markets are achieved in an environment of 'legal certainty'"); Ofer Raban, *The Fallacy of Legal Certainty: Why Vague Legal Standards May Be Better for Capitalism and Liberalism*, 19 B.U. PUB. INT. L.J. 175, 175-76 (2010) (listing quotations by prominent legal thinkers supporting "the idea that bright-line rules are superior to vague standards in regard to certainty and predictability").
 9. Becker, *supra* note 5, at 1871; see also MACEY *supra* note 4, at 241 (positing that "the SEC purposely pursues a strategy of keeping its rules vague and in flux").
 10. Becker, *supra* note 5, at 1873 ("Clarity would serve the cause of deterrence."); see also MACEY *supra* note 4, at 248 ("[T]he government should be compelled to provide clear guidance as to what constitutes illegal insider trading and what constitutes legitimate, albeit aggressive, research."); Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 567 (2011) ("Without clarity about the nature of securities fraud and its relationship to the concept of fraud, the law is likely to impose sanctions inconsistently."); Rob Tricchinelli, *SEC Enforcement Will Be Aggressive, But Lack of Clarity Problematic, Panel Says*, BLOOMBERG BNA (Jan. 10, 2014), <http://www.bna.com/sec-enforcement-will-be-aggressive-but-lack-of-clarity-problematic-panel-says> (noting disagreement among a panel of industry experts about the direction or boundaries of increasingly aggressive SEC enforcement).

will not insulate them from liability, they must be cautious with any activities that seem to violate the spirit of the backstop ambiguity provisions. The certainty of *uncertainty* in the realm just beyond the rules should thus incentivize more ethical behavior, filling the role once played by corporate reputation.

Part 0 of the Note briefly discusses the ever-decreasing emphasis on corporate reputation as a protected company asset, drawing on work by Jonathan R. Macey that “explain[s] what has caused so many firms in the financial industry to lose interest in cultivating and maintaining their reputations for integrity.”¹¹

Part 0 describes and critiques the general bias in favor of legal certainty. The well-worn literature on rules and standards explains that clear-cut rules offer the promise of predictability, but run the risk of being over- or underinclusive. Financial regulation has become increasingly complex, but we must resist the temptation to sacrifice substantive efficacy for administrative efficiency.

Part 0 lays out the Note’s proposal of bright-line rules bolstered by backstop ambiguity. This proposal is not intended to resolve the general debate about the proper level of specificity in the law, but rather to make suggestions in the particular regulatory context of the financial industry. Part 0 defines backstop ambiguity and compares it to similar but distinct concepts like safe harbors, principles-based regulation, and constructive ambiguity. The theoretical advantages and risks of backstop ambiguity are discussed in a general way, and then illustrated with examples from the regulation of tender offers and insider trading.

Part 0 makes normative claims about which circumstances are more appropriately regulated by specific rules as opposed to vague standards. It then discusses considerations of regulatory design aimed at maximizing the success of the backstop ambiguity model.

The Conclusion offers general recommendations on how corporate leaders in the financial industry should respond to a system of backstop ambiguity (including the version currently being exercised by the SEC and DOJ). Enforcement actions may be triggered by the improper conduct of individual employees, but sanctions are likely to be levied against the entire corporation by suit or settlement. The threat of large penalties for conduct in the gray area beyond specific rules should prompt CEOs and boards of directors to infuse the corporation with a culture of compliance and develop strong monitoring systems to protect shareholder value against both monetary penalties and reputational harm.

11. MACEY, *supra* note 4, at 1.

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

I. A DECLINING EMPHASIS ON CORPORATE REPUTATION

A. The Reputation Model

“Corporate finance and capital markets traditionally relied heavily on the ability of companies and other firms to develop what is known as reputational capital.”¹² The reputation model posits that because financial transactions are so complex, because luck and ever-shifting market conditions can make it difficult to measure the success of any particular trader or transaction, and because money is a fungible asset that often exists only on paper, corporations should cultivate a reputation for integrity and fair dealing in order to attract investors.¹³ Reputations take time to build, but can be destroyed instantly in a high-profile scandal. Companies therefore have an incentive to err on the side of caution, since the short-term profit to be gained from unscrupulous behavior is unlikely to exceed the long-term harm wrought by a ruined reputation should the unethical conduct be discovered.¹⁴

The reputation model certainly applies to investment banks,¹⁵ but Macey’s inquiry also extends to the related industries of “credit rating agencies, law firms, . . . stock exchanges, and accounting firms.”¹⁶ These entities play a role in the “reputation industry,” since their familiar names lend an imprimatur of legitimacy to financial statements, transactional documents, or investment products.¹⁷ Like the financial companies who hired them, these organizations should have a long-term interest in preserving a reputation for integrity. After all, a seal of approval is only worth as much as the name it carries.

12. *Id.*

13. *See id.* at 7-8.

14. *See id.* at 8.

15. *See* Stephen M. Davidoff et al., *The SEC v. Goldman Sachs: Reputation, Trust, and Fiduciary Duties in Investment Banking*, 37 J. CORP. L. 529, 533 (2012) (“Historically, . . . [r]eputation, the wellspring from which trust flowed, was the central asset for investment banks.”).

16. MACEY, *supra* note 4, at 1.

17. *See id.* at 124-25 (defining and discussing the reputation industry); *see also* Davidoff et al., *supra* note 15, at 541 (explaining that in “[t]rust-based transactions[,] . . . a trusted intermediary can put its reputation at stake by guaranteeing the quality of goods, or by guaranteeing its own or another counterparty’s behavior”).

B. *"The Death of Corporate Reputation"*¹⁸

The reputation model has theoretical appeal and historical support, but the general consensus is that the financial industry as a whole no longer prioritizes reputation the way it once did. The fallout of the financial crisis rang a plangent death knell for the reputation model,¹⁹ and one of the loudest reverberating echoes was a *New York Times* opinion piece entitled "Why I Am Leaving Goldman Sachs."²⁰ Departing Goldman executive Greg Smith indicted the firm's "toxic and destructive" culture, feeding popular perceptions of greedy bankers by noting "how callously people [at Goldman] talk about ripping their clients off."²¹ Smith blamed the shift in culture on leadership, alleging that the prior emphasis on "setting an example and doing the right thing" gave way to a focus on "how we can make the most possible money off of [clients]."²²

Academics acknowledge the importance of corporate leadership,²³ but explain the altered corporate culture by pointing to deeper secular shifts in the financial industry. Individual reputation has increasingly come to replace institutional reputation: the ascendancy of limited liability structures over partnership structures and closely held corporations has reduced personal accountability for the risks of the overall venture,²⁴ and improvements in information technology now facilitate easy background research on the track records of individual traders.²⁵ Advances in technology and economic modeling have also "codified many formerly tacit elements of investment banking," giving it more of a quantitative, transactional feel.²⁶ As Macey states, financial transactions "have

18. Part I draws heavily on a book of the same name by Jonathan R. Macey. See MACEY, *supra* note 4.

19. See, e.g., Danny Huizinga, *Is Wall Street in Decline?*, WASH. TIMES COMMUNITIES (Oct. 13, 2013), <http://communities.washingtontimes.com/neighborhood/consider-again/2013/oct/13/wall-street-decline> (explaining that "Wall Street took more than a financial hit from the recession," pointing to its "lackluster reputation" and noting that "[t]he perception of financial managers and investment bankers as greedy has turned off many people from the industry").

20. Greg Smith, Op-Ed., *Why I Am Leaving Goldman Sachs*, N.Y. TIMES, Mar. 14, 2012, at A27.

21. *Id.*

22. *Id.*

23. See Donald L. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209, 1241 n.144 (2011) ("There is a substantial literature on the psychology of CEO's and its influence on corporate decision making and performance.").

24. See MACEY, *supra* note 4, at 93-96; Davidoff et al., *supra* note 15, at 543.

25. See MACEY, *supra* note 4, at 96-99.

26. Davidoff et al., *supra* note 15, at 530.

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

become so complex that rocket scientists who design complex financial instruments have replaced simple, high-reputation practitioners of ‘Old School Finance.’”²⁷

II. A MISPLACED EMPHASIS ON LEGAL CERTAINTY

The question is where we go from here. Corporations no longer voluntarily seek to preserve their own reputations, and the current regime of securities regulation draws criticism from all sides.²⁸ This Part critiques the bias in favor of legal certainty in the financial industry, paving the way for a discussion of back-stop ambiguity in Part 0.

A. *The Bias in Favor of Legal Certainty*

In normative discussions of policy design and judicial interpretation, an ever-present issue is the proper use of specific, bright-line rules as opposed to more ambiguous, context-dependent standards.²⁹ The expansive literature exploring the question of whether there is a preferable approach generally concludes that there is no neat transsubstantive answer, since rules and standards offer contrasting sets of risks and benefits that may be more appropriate for particular types of situations or more appealing to particular ideological orientations.³⁰

27. MACEY, *supra* note 4, at 2.

28. See Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2231 (2010) (“[T]he status quo approach to securities fraud deterrence in the United States is mostly the product of historical accident and has few disinterested defenders.”).

29. The prototypical comparative example is a rule defining the speed limit as “fifty miles per hour,” as contrasted with a standard defining the speed limit as “a reasonably safe speed in light of the circumstances at the time.” As illustrated in that example, “[a] rule withdraws from the decision maker’s consideration one or more of the circumstances that would be relevant to decision according to a standard.” Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 258 (1974). “The difference between a rule and a standard is a matter of degree—the degree of precision,” but “[t]o facilitate exposition, [authors] will sometimes treat the specificity-generality continuum as if it were a dichotomy between ‘rules’ and ‘standards.’” *Id.*

30. See, e.g., Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 76 (1983) (“The degree of precision appropriate to any particular rule depends on a series of variables peculiar to the rule’s author, enforcer, and addressee. As a consequence, generalizations about optimal rule precision are inherently suspect.”); Ehrlich & Posner, *supra* note 29, at 257 (“Any choice along the specificity-generality continuum will generate a unique set of costs and benefits.”); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 383 (1985) (noting the “patterned sets of ‘canned’ pro and con arguments about the value of adopting either rules or standards in particular contexts”).

Nonetheless, some voices within the academic community consistently call out for clear rules and legal certainty.³¹ This steady drumbeat can be heard across substantive doctrinal lines, and its predictable rhythm is both familiar and attractively intuitive³²: as compared to ambiguous standards, rule enforcement tends to be more straightforward for adjudicators and more predictable for regulated entities, which makes it less costly and less controversial.³³

Along the same lines, a number of commentators have called for greater specificity in financial regulation and more predictability in SEC and DOJ enforcement.³⁴ Securities regulation already includes a number of specific rules on topics like registration statements, disclosures, and other filings by public companies,³⁵ but there remain yawning caverns of ambiguity in areas like fraud and insider trading.³⁶ It is these latter provisions that proponents of specificity have targeted for reform.

The bias in favor of legal certainty has been criticized on general grounds, relying in large part on the recognition that “rules are always either over- or underinclusive with respect to their purposes.”³⁷ That is, rules tend to be either so expansive that they cover types of conduct that would *not* cause the harm targeted for prevention, or so limited in scope that they fail to address conduct that *would* cause such harm. This lack of fit with purpose not only poses philosophical issues of regulatory legitimacy, but also undermines one of the main selling points of specific rules. If the rule as applied does not map onto our expectations of its purpose and scope, then the predictability of applying the rule in an enforcement context may not translate into actual legal predictability for

31. See *supra* note 8 and accompanying text.

32. See Shawn J. Bayern, *Against Certainty*, 41 HOFSTRA L. REV. 53, 53 (2012) (“In legal argumentation, appeals to certainty and predictability have enormous rhetorical power.”); Joanna Perkins, *Legal Certainty and the Role of the Financial Markets Law Committee*, 2 CAPITAL MARKETS L.J. 155, 156 (2007) (noting the “high profile and importance currently accorded to legal certainty and subsidiary values”); Raban, *supra* note 8, at 179 (“The claims that strictly construed clear and determinate legal rules are essential for capitalism and liberalism are intuitive and widespread.”).

33. See James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CALIF. L. REV. 115, 119 (2012).

34. See *supra* notes 8-10 and accompanying text.

35. See Park, *supra* note 33, at 133.

36. See *supra* text accompanying note 9; see also MACEY, *supra* note 4, at 248 (“For decades, the SEC has kept the insider trading rules vague and undefined.”); Park, *supra* note 33, at 133 (noting that “fraud is defined at a high level of generality”).

37. Mark V. Tushnet, *Playing with the Rules*, 90 MICH. L. REV. 1560, 1560 (1992) (reviewing FREDERICK SCHAUER, *PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISION-MAKING IN LAW AND LIFE* (1991)); see also Ehrlich & Posner, *supra* note 29, at 268 (“[T]he reduction of a standard to a set of rules must in practice create both overinclusion and underinclusion.”).

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

regulated actors as they make decisions in everyday situations.³⁸ This risk is particularly acute if those actors are not legally sophisticated repeat players who closely track enforcement patterns and changes in law.³⁹ It is in part for this reason that the benefits of certainty in financial regulation may “accrue mainly to large financial institutions and other market intermediaries” rather than “borrowers or consumers.”⁴⁰

B. The Impossibility of Certainty in Effective Financial Regulation

Underinclusivity is the bane of efficacious financial regulation. Rules aimed at protecting investors or preventing misleading conduct often include explicit or implied exclusions that seem designed to undermine efficacy. Such gaps may be due to concessions arising out of the financial industry’s massive political clout,⁴¹ or may simply reflect the inevitable processes of innovative evasion.⁴² With clever lawyers and bankers at their disposal, regulated entities can often find ways around bright-line definitions; indeed, the counterpoint to predictability’s value in promoting efficiency is that it can also map out a safe path through the carefully delineated violations and exemptions. This type of evasion may be particularly common in the “area of corporate and financial regulation, in which sophisticated and resourceful actors pair with complex law to produce at times maddening and costly games of regulatory cat-and-mouse.”⁴³ As a result, even rules that seem to be overinclusive as written may not end up playing out that way in practice.

38. See Bayern, *supra* note 32, at 56; Raban, *supra* note 8, at 179.

39. See Raban, *supra* note 8, at 185-86.

40. Diane Lourdes Dick, *Legal Ethics, Commercial Practice, and the Certainty Imperative: A Cautionary Note*, 40 N. KY. L. REV. 279, 289 (2013).

41. See Lawrence G. Baxter, “Capture” in *Financial Regulation: Can We Channel It Toward the Common Good?*, 21 CORNELL J.L. & PUB. POL’Y 175, 182 (2011) (listing evidence that “our financial and economic public policy process has been systematically captured by large-scale financial interests”); Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L. REV. 1283 (2013) (discussing industry influence with national legislators and regulators).

42. See Cristie Ford, *Macro- and Micro-Level Effects on Responsive Financial Regulation*, 44 U. B.C. L. REV. 589, 612 (2011) (explaining that “some of the innovations that firms [engage] in [are] expressly designed to circumvent compliance requirements”).

43. Samuel W. Buell, *Good Faith and Law Evasion*, 58 UCLA L. REV. 611, 612 (2011); see also Hersh Shefrin, *Building on Kahneman’s Insights in the Development of Behavioral Finance*, 44 LOY. U. CHI. L.J. 1401, 1409 (2013) (noting that in finance, “[l]egislation is a tug-of-war, in constant motion,” which continues “even after the passage of legislation . . . when adherents to different positions fight over interpretation and implementation”).

The SEC's allowance of "10b5-1 plans" provides an example of corporate executives' ability to discover and exploit flaws of regulatory design. Rule 10b5-1 carves out an exception from the agency's general prohibition on insider trading,⁴⁴ allowing insiders to draft written plans for trades in prespecified amounts on prespecified future dates.⁴⁵ Any trade carried out in accordance with such a plan is insulated from liability for insider trading under Rule 10b-5.⁴⁶ This provision was added in 2000 in order to "creat[e] a safe harbor for those [insiders] who needed to liquidate their shares for diversification, large purchases, and other legitimate personal reasons."⁴⁷

As it turns out, the well-intentioned rule is also eminently susceptible to manipulation. The obvious ploy lies in simply declining to exercise a 10b5-1 plan when the outcome is expected to be unfavorable. More nefarious potential tactics include adjusting the timing of important corporate disclosures or making other decisions as an officer in an attempt to swing stock value in the right direction at the right moment.⁴⁸ The empirical evidence lends credence to these suspicions: sales arising out of 10b5-1 plans "systematically follow positive and precede negative firm performance," and "early sales plan terminations are associated with pending positive performance shifts."⁴⁹ Insiders have been relying on their privileged status to manipulate trades, and can do so within the bounds of conduct that the SEC permits.

As an unfortunate corollary of the financial system's complexity, new rules that later turn out to have been misguided can be "very difficult and costly to get rid of" because they "will be taken into account—for good or ill—in a vast number of agreements, deals and structures."⁵⁰ Instead, we end up with waves of reactive legislation and rulemaking, where "deregulation before a crisis leads to heavier regulation after a crisis."⁵¹ This kind of regulatory catch-up is necessary when enforcers are dependent on specific rules that easily pinpoint viola-

44. See 17 C.F.R. §§ 240.10b-5, 10b5-1(a) (2014).

45. See *id.* § 240.10b5-1(c)(1) (2014).

46. *Id.*

47. Karl T. Muth, *With Avarice Aforethought: Insider Trading and 10b5-1 Plans*, 10 U.C. DAVIS BUS. L.J. 65, 66 (2009).

48. See, e.g., *id.* at 70, 77 (summarizing several ways that executives can use inside knowledge and influence to extract additional value from 10b5-1 plans).

49. Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade*, 55 MGMT. SCI. 224, 224 (2009), available at <http://pubsonline.informs.org/doi/pdf/10.1287/mnsc.1080.0928>; see also Brandon C. Parris, *Rule 10b5-1 Plans: Staying Out of Trouble*, 17 BUS. L. TODAY 21, 21 (2008) (listing other studies that found suspiciously consistent evidence of 10b5-1 plans beating the market).

50. Perkins, *supra* note 32, at 157.

51. Shefrin, *supra* note 43, at 1409; see also Dick, *supra* note 8, at 1468 ("Finance and lending law reform is often reactionary, developed *ex post* in the wake of an economic downturn.").

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

tors, but which provide little flexibility to target similarly harmful behavior that falls outside the rules' narrow scope.

Given these risks, we must not fall prey to the “danger that the concept of ‘legal certainty’ becomes fetishized, and stands in the way of any real evaluation of the merits of law reform.”⁵²

III. PROPOSAL: BRIGHT-LINE RULES AND “BACKSTOP AMBIGUITY”

The predictability afforded by specific rules has immense value in a regulatory regime, but the flaws highlighted in the foregoing discussion show that we cannot rely on rules alone. Part 0 lays out a proposal for supplementing bright-line rules with purposely vague “backstop ambiguity” provisions that capture the spirit of the rules' intent.⁵³ The proposal's advantages and risks are discussed and illuminated through the contrasting examples of tender offers and insider trading.

A. Proposal Overview

1. What Backstop Ambiguity Is

In any given area of regulation, there will likely be certain actions that can be required, incentivized, discouraged, or prohibited through bright-line rules. Standing alone, such a pinpointed approach will be successful only if the harmful conduct can be clearly defined in advance, such as prohibiting certain kinds of pollution.⁵⁴ Even then, regulators will need to remain vigilant and update the

52. Perkins, *supra* note 32, at 162.

53. In proposing a model of backstop ambiguity, this Note does not presume to resolve the general debate about rules and standards. The debate may well have raged on for so long because it has no generalizable answer. See Schlag, *supra* note 30, at 426 (observing that the rules-standards “dialectic is irreducible” and that “[w]e cannot make sense of it in terms other than its own”). In any case, “[a]n appropriate balance between rules and principles in securities regulation may look quite different from the appropriate balance in other regulatory arenas.” Cristie Ford, *Principles-Based Securities Regulation in the Wake of the Global Financial Crisis*, 55 MCGILL L.J. 257, 268 (2010); see also sources cited *supra* note 30 (arguing that the appropriate balance of precision and ambiguity likely varies among regulatory areas). For examples of doctrine-specific exploration of rules and standards, see Daniel A. Crane, *Rules Versus Standards in Antitrust Adjudication*, 64 WASH. & LEE L. REV. 49 (2007); John F. Duffy, *Rules and Standards on the Forefront of Patentability*, 51 WM. & MARY L. REV. 609 (2009).

54. See Buell, *supra* note 43, at 615 (noting that rule-based regulation “will be satisfying only if most of the social problem that motivates the project of regulation . . . is produced by actors falling within the core and not along the margins of a legal rule”).

specific rules in response to new types of conduct not explicitly covered by existing law.⁵⁵

Regulators should take advantage of the predictability and efficiency of clear rules whenever possible, but should bolster their enforcement arsenal with vague standards that create a buffer zone around specifically regulated conduct. This is what I term “backstop ambiguity,” a set of broad provisions that rely on a functionalist analysis to identify and punish conduct that thwarts the purpose of specific rules without triggering any of their enumerated violations.

A variety of configurations are possible under the umbrella of backstop ambiguity. At the simplest level, a list of specific criteria or procedural requirements can be rounded out with a catch-all provision stated in general terms. For an example, consider Regulation S-K Item 404(a), which compels public corporations to report certain conflicted transactions. The regulation specifies several types of information that must be disclosed, such as the approximate dollar value of the conflicted transaction, the identity of the “related person,” and the nature of that person’s conflict of interest.⁵⁶ Accompanying these specific rules is a provision requiring disclosure of “[a]ny other information regarding the transaction or the related person . . . that is material to investors in light of the circumstances of the particular transaction.”⁵⁷ This catch-all provision is explicitly defined in broad terms that speak to the overall goal of Item 404(a) (that is, ensuring that investors receive relevant information about conflicted transactions), allowing the SEC to conduct a functionalist inquiry that reaches beyond the itemized disclosure requirements.

Taking this purposivist drafting style a step further, regulators could bolster an array of objective procedural rules with a standard that defines an overarching *malum in se* like “fraud” or “misleading conduct.” This is what the SEC has done by prohibiting fraudulent conduct “in connection with the purchase or sale of any security.”⁵⁸ The agency’s conception of “fraud is defined at a high level of generality,”⁵⁹ making it applicable in various contexts that are otherwise regulated by specific requirements for corporate disclosures and transactional procedures. A broad anti-fraud provision may attenuate the need to include a catch-all provision in each set of regulatory specifications. It also allows regulators to target conduct that does not seem to violate any particular rule or even any particular set of rules, but that nonetheless strikes regulators as sufficiently harmful to merit enforcement action. Thus, while a catch-all provision can extend a particular regulation beyond its itemized contents, a broader purposivist approach to backstop ambiguity can actually wrap around whole groups of

55. See *id.* at 614.

56. 17 C.F.R. § 229.404(a) (2014).

57. *Id.* § 229.404(a)(6).

58. See SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2014).

59. Park, *supra* note 33, at 133.

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

rules, filling in interstitial spaces that would otherwise create a safe path between the rules for would-be evaders.

A third way to use backstop ambiguity is to rely on a standard to determine when a given set of rules will apply. This tactic is effectively deployed in the regulation of tender offers, as discussed below in Part III.C.1.

In terms of public policy actors, a backstop ambiguity structure in any particular area of regulation could potentially be created, modified, or updated by any branch of government. Congress could write legislation that combines a standard with more specific rules. A legislative standard could be filled in by regulators or courts with interpretive line drawing. Meanwhile, a statutory rule could have ambiguity added around it if an agency or court adopted an imprecise trigger or found a way to build a “totality of the circumstances”-type test into one of the criteria.

2. What Backstop Ambiguity Is Not

To help illustrate this Note’s backstop ambiguity proposal, it may be helpful to contrast backstop ambiguity with three related concepts that have been discussed in the literature: safe harbors, principles-based regulation, and constructive ambiguity. Like cousins on a family tree, they have certain features in common, but also have important distinctions that highlight each concept’s unique elements.

Safe harbors are structurally similar to backstop ambiguity in that both devices involve pairing standards with rules. The key difference, however, is that safe harbors are disjunctive: “[t]he basic form of a safe harbor allows a regulated entity to *choose between* compliance with either a standard or a rule.”⁶⁰ If a regulated entity complies with the rule, it falls within the safe harbor and is thus protected from being analyzed under the standard. In backstop ambiguity, by contrast, the intent is to apply both the standard *and* the rule.

The safe harbor structure works particularly well where the precise parameters of permitted conduct for a subgroup of the regulated population can be circumscribed with rules.⁶¹ Alternatively, rule drafters may hope to incentivize a

60. Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349, 369 (1993) (emphasis added). “The typical pattern is to have a general, usually vague, standard that restricts activity by the regulated entity. A second, more specific, rule is then promulgated, which provides the ‘safe harbor’ by specifying activity that will be deemed to meet the general standard.” *Id.* at 369-70.

61. *Id.* at 373. Of course, a rule does not shed its risks simply by masquerading under another name, as evidenced by the regrettable insider trading safe harbor for 10b5-1 plans discussed in the previous section. *See supra* notes 44-49 and accompanying text.

particular type of conduct, and use the safe harbor to lure actors who would otherwise be disinclined to behave in the desired way.⁶²

The two policy devices thus operate in opposite directions. Safe harbors carve out a category of activity that is protected from consideration under a standard; backstop ambiguity ensures that regulated entities are *not* insulated from liability under the standard if they find a way to comply with the text of bright-line rules without honoring their spirit. If a safe harbor welcomes ships in to protect them from stormy seas, backstop ambiguity acts more like a lighthouse, warning vessels to steer well clear lest they crash on rocky shoals. Like literal harbors and lighthouses, the two policy devices can work in concert, but should not be confused as performing similar functions.

Safe harbors are related to backstop ambiguity in that they are policy devices with structural similarities, though they aim to achieve different ends. Principles-based regulation is a cousin from another part of the family tree⁶³; it shares the basic goals of backstop ambiguity, but operates at a higher level of generality as a “*philosophy or style of financial regulation*” that “is concerned with *who* generates substantive regulation . . . within regulatory regimes and *how*, as opposed to the institutional structure, statutory construction, or substantive content of regulation.”⁶⁴

Finally, we reach constructive ambiguity, a policy device aimed at mitigating the moral hazard caused by governments’ willingness to bail out systemically important financial institutions and lenders of last resort. The premise of constructive ambiguity is a promise that in the event of failure, the government

62. The Private Securities Litigation Reform Act (PSLRA), for example, introduced a safe harbor in the regulation of forward-looking corporate disclosures, shielding from private litigation any disclosure that “is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially” from the predictions made. 15 U.S.C. § 78u-5 (2012). The PSLRA’s legislative history reveals that Congress had two goals in crafting the safe harbor: to reduce abusive private securities fraud suits based on forward-looking statements and to encourage disclosures of forward-looking information by corporate officials. See Ann Morales Olazábal, *False Forward-Looking Statements and the PSLRA’s Safe Harbor*, 86 IND. L.J. 595, 618 (2011) (“[T]he safe harbor provision was not targeted solely at reduction in strike suits as were many of the other substantive and procedural provisions of the PSLRA. Instead it had another express purpose, that of promoting corporate disclosure of forward-looking information.”) (internal footnote omitted).

63. Principles-based regulation is also from an international branch of the family, having been primarily discussed in the United Kingdom, Australia, and Canada. See Dan Awrey, *Regulating Financial Innovation: A More Principles-Based Proposal?*, 5 BROOK. J. CORP. FIN. & COM. L. 273, 273-74 (2011).

64. *Id.* at 273 (emphasis in original); see also Ford, *supra* note 53, at 278 (defining principles-based regulation as a “two-tiered approach” involving “legislative drafting” supplemented by “constantly evolving industry experience and regulatory rules”).

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

will only bail out some institutions some of the time.⁶⁵ This notion is premised on the unpredictability of assistance for a subset of critical financial institutions, whereas backstop ambiguity pertains to uncertainty in the scope of the prohibitions in financial regulation more generally. The two concepts thus involve quite dissimilar considerations.

B. A Theoretical Assessment of Backstop Ambiguity

1. The Advantages of Backstop Ambiguity

The primary advantages of backstop ambiguity are its flexibility and adaptability. These two related concepts reflect the importance of contextualized enforcement, where regulators are responsive to changing conditions and fact-specific inquiries.⁶⁶ Only then will regulation most effectively deter harmful conduct.

Regulatory flexibility is a solution to the dilemma of over- and underinclusivity discussed above.⁶⁷ A flexible standard allows regulators to target instances of bad behavior that would fall outside the ambit of narrowly drawn underinclusive rules, but without the need for overinclusive rules that would penalize benign behavior.⁶⁸ Given the inherent tendency toward underinclusion in the design and implementation of rules in the financial sector,⁶⁹ backstop ambigu-

65. See James B. Thomson, *On Systemically Important Financial Institutions and Progressive Systemic Mitigation*, 8 DEPAUL BUS. & COMM. L.J. 135, 147-48 (2010); see also Alison M. Hashmall, Note, *After the Fall: A New Framework to Regulate "Too Big To Fail" Non-Bank Financial Institutions*, 85 N.Y.U. L. Rev. 829, 843 (2010); Marvin Goodfriend & Jeffrey M. Lacker, *Limited Commitment and Central Bank Lending* 19-20 (Fed. Reserve Bank of Richmond, Working Paper No. 99-2, 1999), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2180933. The term "constructive ambiguity" was actually adopted from another context: it was first used to describe a strategy of intentional vagueness in international negotiations, where "[e]ach side knows that [an agreement] is a 'fudge' but can live with it, and 'sell' it to their own constituents as victory, or at least not a defeat." Christine Bell & Kathleen Cavanaugh, *"Constructive Ambiguity" or Internal Self-Determination? Self-Determination, Group Accommodation, and the Belfast Agreement*, 22 FORDHAM INT'L L.J. 1345, 1356 (1999). The term's use in financial markets is obviously quite different, and neither meaning is particularly relevant for this Note's discussion of backstop ambiguity.

66. Cf. Bayern, *supra* note 32, at 55-56 (discussing three kinds of contextual judgments that common law can make to improve the application of rules).

67. See *supra* notes 37-40 and accompanying text.

68. This seemingly intuitive pairing has been hinted at in a general way prior works. See, e.g., Ehrlich & Posner, *supra* note 29, at 268 (noting that "[t]he problem of underinclusion can be solved by backing up [a] rule with a standard").

69. See *supra* notes 41-43 and accompanying text.

ty can play an important role in punishing (and therefore deterring) evasive behavior.⁷⁰

The term “flexibility” as used here pertains to individual enforcement actions that could not be brought based solely on underinclusive bright-line rules. “Adaptability” refers to the progression of the regulatory regime itself over time. If regulators find that they are consistently relying on the backstop ambiguity provision for a particular type of conduct, they may wish to promulgate rules or release guidance on the matter. The backstop allows them to identify and address enforcement gaps in the existing rules, but without letting harmful conduct go unpenalized in the interim.⁷¹

This is an alternative approach to what Charles Whitehead refers to as “staged regulation.”⁷² Whitehead advocates for discretionary staged implementation of prespecified blocks of new rules, allowing regulators to assess the impact of each incremental regulatory alteration before deciding whether to proceed with the next one. Backstop ambiguity achieves the same effect in a more fluid manner, avoiding the cost of drafting a long string of potential modifications that may or may not ever prove necessary, but preserving the benefit of testing a new approach before formally codifying it in new rules.⁷³

If implemented correctly, backstop ambiguity should create a zone of deterrence beyond the bright-line rules. Asking whether a potentially problematic behavior is covered under a rule yields a binary outcome: either it is written into the rule, or it is not. Ambiguity purposely blurs the lines of legality, incentivizing caution, self-reflection, and self-policing on the part of regulated entities. Where once companies emphasized ethics for the sake of preserving their reputation, they may now do the same thing for the sake of steering well clear of the regulatory gray area, with its landmines of large but unpredictable punishments.

As previously mentioned, this approach should not be characterized as mere uncertainty. Bright-line rules must be predictably enforced, and the halo of uncertainty only extends so far, though its outer limit may be indistinct. It is

70. See Buell, *supra* note 43, at 616 (suggesting that the law could “attack[] the problem of evasion by bolstering primary rules of law with supplemental doctrine designed to identify evaders”).

71. See Ehrlich & Posner, *supra* note 29, at 277 (“Obsolescence is not so serious a problem with regulation by standard.”).

72. See Charles K. Whitehead, *The Goldilocks Approach: Financial Risk and Staged Regulation*, 97 CORNELL L. REV. 1267 (2012).

73. SEC no-action letters, for example, are much less costly to issue than formal rules, but regulated entities pay close attention to them and treat them as if they have force of law. See, e.g., Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 CORNELL L. REV. 921, 953-57 (1998). Published no-action letters represent one way the SEC can clarify the boundaries of an ambiguous standard over time, possibly following up with specific rules to carve out exemptions or codify violations.

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

the certainty of this liminal *uncertainty* that creates the deterrent effect: regulated entities know they cannot exploit loopholes, so they should strive to conform to the spirit of the law rather than simply its text.⁷⁴

2. The Risks of Backstop Ambiguity

There are two principal risks of building backstop ambiguity into the regulatory system: abuse of enforcement discretion and unreasonable costs due to overdeterrence. This section describes those risks, leaving the question of how to mitigate them for the later discussion of regulatory design.⁷⁵

Ambiguous standards inevitably increase the amount of discretion in the hands of those who enforce them. The specificity of rules serves to cabin the power of enforcers to the violations enumerated therein, while the generality of standards allows enforcers to sanction a wide array of behaviors they determine to be objectionable.⁷⁶ The proper degree of latitude afforded to law enforcement officials is a matter of eternal debate.⁷⁷ Personal discretion in applying ambiguous standards can produce inconsistent results, which offends basic notions of fairness.⁷⁸ Enforcers may also be subject to insidious political pressures, personal motives of glory or retribution, or outright corruption.⁷⁹

Courts can play a role in monitoring prosecutorial decisions,⁸⁰ as the Supreme Court did when it rejected the SEC's theory of insider trading as defined simply by a lack of informational parity and held that the requisite element of

74. For greater detail and proposed approaches for the financial industry to respond to backstop ambiguity, see *infra* notes 152-65 and accompanying text.

75. See *infra* Part IV.

76. See Park, *supra* note 33, at 130-31.

77. See, e.g., Russell M. Gold, *Promoting Democracy in Prosecution*, 86 WASH. L. REV. 69, 72 (2011) (noting the “many previous articles and books that have quarreled with the breadth of prosecutorial discretion”). The debate over prosecutorial discretion in the securities context is further complicated by the fact that there are multiple groups of potential enforcers: the SEC, public enforcement authorities (federal prosecutors and state attorneys general), private self-regulatory organizations, and private plaintiffs (typically guided by motivated plaintiff-side attorneys). These enforcers have divergent motivations, and thus take different approaches in pursuing legal action. See generally Park, *supra* note 33, at 143-62.

78. See Raban, *supra* note 8, at 191.

79. See MACEY, *supra* note 4, at 118-19 (arguing that SEC staffers who specialize in highly complex regulatory enforcement are more likely to “garner top-paying jobs on Wall Street” after leaving the agency); Anderson, *supra* note 7, at 15 (“[F]ederal prosecutors effectively have managed to criminalize both correct and incorrect economic decisions, tapping into political discontent and looking for scapegoats.”).

80. See Dick, *supra* note 8, at 1485 (noting that “the judiciary has taken an active role” in interpreting and enforcing federal securities laws).

punishable insider trading is the use of information that was misappropriated.⁸¹ The courts' influence is somewhat moderated, however, by the SEC's pervasive tendency to settle out of court rather than proceeding with a trial.⁸²

Prosecutorial discretion could also manifest as underenforcement. Some critics have pointed to the SEC as an institution suffering from deep regulatory capture, where the interests of powerful private actors not only receive favorable treatment in individual cases, but also work in long-term ways to systematically restructure the overall financial regulatory infrastructure.⁸³ Captured regulators may choose to tightly limit the reach of a backstop ambiguity provision, or may simply decline to enforce it. Of course, this concern is applicable to any regulatory model, irrespective of the balance of rules and standards; it may well be that standards are more susceptible to underenforcement because their precise scope is at the discretion of the regulators, but there is ample evidence that violations of bright-line rules may also go unpunished in certain contexts.⁸⁴ Regulatory capture and lazy enforcement are thus broader worries that are not specific to this Note's discussion of backstop ambiguity.

The second potential problem with backstop ambiguity is the risk of over-enforcement. Zealous expansion of liability under vague standards "could create a chilling effect where parties will be overly cautious for fear that they will be punished for acts that a regulator determines *ex post* is misconduct."⁸⁵ Even if prosecutors are not consistently aggressive in their enforcement, a lack of predictability may nonetheless produce a chilling effect among more risk-averse market actors, and may increase transaction costs as parties debate with each other over both where the line of legality lies and how likely it is that enforcement will actually occur.

81. See *U.S. v. O'Hagan*, 521 U.S. 642 (1997).

82. See MACEY, *supra* note 4, at 215 (noting that firms "settle nearly all the cases brought against them"). But see Joshua Gallu, *SEC Trials Increase 50 Percent as Execs Fight Lawsuits*, BLOOMBERG (May 22, 2012, 6:00 AM), <http://www.bloomberg.com/news/2012-05-22/sec-trials-increase-50-percent-as-execs-fight-lawsuits.html> (describing a recent "surge in the number of executives and companies willing to go to trial to defend themselves").

83. See Baxter, *supra* note 41, at 181-83 (explaining that the concept of regulatory capture is "very relevant in the context of contemporary financial regulation," which suffers from both shallow and deep capture). See generally Wilmarth, *supra* note 41.

84. See *infra* Part IV.B.3.

85. Park, *supra* note 33, at 142; see also Rose, *supra* note 28, at 2185 ("The more ambitious the fraud prohibition, the greater potential reduction in underdeterrence costs and the greater potential *increase* in overdeterrence costs.") (emphasis added).

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

C. Examples of Backstop Ambiguity

This section briefly traces the outlines of existing backstop ambiguity in two areas of securities law. Tender offer regulation includes a complementary pairing of bright-line rules and supporting ambiguity, while a similar structure in insider trading has generated criticism and controversy for its uncertain aims and inconsistent interpretations. These examples highlight the advantages and risks discussed in the prior section, and also emphasize the degree to which backstop ambiguity is reliant on a purposivist, functionalist analysis. Backstop ambiguity should be used to reinforce—not shift or change—the overall purpose of a set of rules. If that purpose is unclear, then backstop ambiguity may produce inconsistent or unpredictable enforcement.

1. Tender Offers: Specific Rules, Vague Trigger

In the hostile takeover wave of the 1960s,⁸⁶ Congress passed the Williams Act to equalize power between hopeful acquirers and potential targets.⁸⁷ The SEC played a role in shaping the content of the legislation, successfully fending off an initial bill with a decidedly anti-takeover slant.⁸⁸ The Williams Act introduced a number of procedural requirements for tender offers, including extensive disclosures⁸⁹ and measures to protect shareholder flexibility.⁹⁰

The Williams Act contained two backstop ambiguity features that helped to maximize regulatory efficacy in the tumultuous world of hostile takeovers. First, the Act included a standard provision prohibiting “any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer.”⁹¹ The Act also included a second type of ambiguity: “[t]he Williams Act regulated tender offers, but intentionally did not define what constituted a tender offer triggering the Act’s substantive and procedural requirements.”⁹²

86. See generally PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 44-51 (5th ed. 2010) (discussing the “third wave” of takeover activity from 1965-1969, which was characterized by a higher number of hostile takeovers than prior merger waves).

87. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2012)).

88. See Steven M. Davidoff, *The SEC and the Failure of Federal Takeover Regulation*, 34 FLA. ST. U. L. REV. 211, 217-18 (2007) (discussing the originally introduced version of the Williams Act, S. 2731, 89th Cong. § 2 (1965)).

89. See 15 U.S.C. § 78n(d)(1) (2012).

90. See, e.g., *id.* § 78n(d)(5) (allowing shareholders to withdraw their tender); *id.* § 78n(d)(7) (requiring a bidder to pay the same price to all tendering shareholders).

91. *Id.* § 78n(e).

92. Davidoff, *supra* note 88, at 221; see also Charles T. Haag & Zachary A. Keller, *Honored in the Breach: Issues in the Regulation of Tender Offers for Debt Securities*, 9

The SEC sought to “establish[] an expansive view of this definition” in order to extend the reach of the Williams Act.⁹³ Its wish was granted when the Southern District of New York’s decision in *Wellman v. Dickinson* enumerated a far-reaching eight-factor test⁹⁴ that was soon adopted by other courts.⁹⁵ Importantly, a court may decide that a certain transaction qualifies as a tender offer even if not all eight of the *Wellman* factors are satisfied.⁹⁶ Would-be acquirers who seek to gain a large block of shares in a short time period must therefore proceed with caution, lest an informal solicitation be retroactively interpreted as a tender offer in violation of the Williams Act’s procedural requirements.

Because of this backstop ambiguity, the SEC manages to shepherd many different kinds of transactions into the protective ambit of the Williams Act. Critically, it has done so without unduly impairing predictability: regulated entities that are unsure whether a proposed transaction will trigger the Williams Act can write to the SEC and request a “no-action letter” (a declaration from the SEC that they will take “no action” against the entity if it proceeds with the transaction as described). Because these letters are published for all to see,⁹⁷ they “have developed into an area of law that lacks a clear *de jure* power but produces real-world practices that define the law’s parameters for practitioners.”⁹⁸ The advantages of this informal clarification in the zone of backstop ambiguity are clear: “the SEC is able to promulgate new policies responding to changing market conditions in a way that spares administrative cost and effort while also allowing the Commission the maximal degree of flexibility and discretion.”⁹⁹

N.Y.U. J.L. & BUS. 199, 204 (2012) (“The term ‘tender offer’ is not defined in the Exchange Act or in other U.S. federal securities laws.”).

93. Davidoff, *supra* note 88, at 221.

94. *Wellman v. Dickinson*, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979). The court looks for factors such as widespread solicitation of shareholders, a premium over market price, offers with fixed rather than negotiable terms, and offers with limited time periods. *Id.*

95. See Davidoff, *supra* note 88, at 222 n.76 (“The standard annunciated in *Wellman* quickly became the judicial norm for determination of a tender offer under the Williams Act.”).

96. See *Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47, 57 (2d Cir. 1985) (“[I]n any given case a solicitation may constitute a tender offer even though some of the eight factors are absent.”).

97. See *Staff No Action, Interpretive and Exemptive Letters*, U.S. SEC. & EXCH. COMM’N, <http://www.sec.gov/divisions/corpfin/ct-noaction.shtml> (last visited Jan. 14, 2014).

98. Haag & Keller, *supra* note 92, at 210; see also Nagy, *supra* note 73, at 953-57 (noting that regulated entities typically adhere to no-action letters as if they had the force of law).

99. Haag & Keller, *supra* note 92, at 248. Haag and Keller’s article discusses the use of no-action letters in the context of debt offerings, a particularly ambiguous class of securities under the Williams Act.

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

The structure of tender offer regulation was designed with built-in backstop ambiguity, but unfortunately, the SEC has failed to maximize the utility of that structure by keeping it up to date. No-action letters have no real legal authority, meaning that multiple iterations of guidance can ultimately produce a system that offers practical predictability, but which bears little resemblance to the law as codified in statute, regulation, and judicial and adjudicative decisions.¹⁰⁰ What the SEC should be doing is “us[ing] the no-action letter process as a bridge to a potential rule change.”¹⁰¹ More broadly, some commentators argue that takeover law in general is simply outdated and requires a substantive overhaul.¹⁰² Backstop ambiguity allows for tweaking at the margins, but it should not be used to shift the direction and focus of an entire body of existing rules.

2. Insider Trading: Vague Standards, Vague Norms

Like tender offers, insider trading is regulated by a mixed set of bright-line rules and ambiguous standards. Section 16 of the Securities Exchange Act of 1934 provides strict liability for trades by statutorily defined “insiders.”¹⁰³ Rule 10b-5 backs it up with a broad prohibition on any fraudulent or misleading conduct “in connection with the purchase or sale of any security.”¹⁰⁴ The SEC has also occasionally promulgated rules defining specific categories of violations—such as sharing or trading based on non-public information pertaining to a tender offer¹⁰⁵—or clarifying elements of liability—such as the duty of confidentiality between family members in tipper/tippee situations.¹⁰⁶

On its face, this system would seem to provide the ideal backstop ambiguity set-up. In practice, however, the SEC’s enforcement of insider trading law is of-

100. See generally *id.* (arguing that this has become the case for regulation of tender offers and debt offerings).

101. *Id.* at 256; see also *supra* notes 72-73 and accompanying text.

102. See, e.g., Davidoff, *supra* note 88, at 247-61.

103. See Securities Exchange Act of 1934, Pub. L. No. 73-291, § 16, 48 Stat. 881, 896 (codified as amended at 15 U.S.C. § 78p (2012)).

104. Rule 10b-5, 17 C.F.R. § 240.10b-5 (2014). This rule was promulgated pursuant to the SEC’s authority under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2012), which prohibits “any manipulative or deceptive device or contrivance” in connection with the purchase or sale of securities.

105. See Rule 14e-3, 17 C.F.R. § 240.14e-3 (2014).

106. See Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2014) (assigning a default “duty of trust or confidence” to immediate family relations). This rule was promulgated in response to the Second Circuit’s holding in *U.S. v. Chestman* that “[m]ere kinship does not of itself establish a confidential relation.” 947 F.2d 551, 568 (2d Cir. 1991) (internal quotation marks omitted).

ten accused of being convoluted, inconsistent, and counterproductive.¹⁰⁷ These critiques may simply reflect the deeper problem that there is no general consensus on the purpose or proper scope of insider trading law. Scholars disagree on whether the costs of regulating insider trading exceed the costs of permitting it.¹⁰⁸ The SEC and the Supreme Court have gone back and forth on the proper theory of insider trading liability, with the Court ultimately rejecting the SEC's theory of informational parity between trading partners in favor of a theory based on the misappropriation of inside information.¹⁰⁹ Even so, it is unclear precisely what this theory means or whether it represents a clean break from prior interpretations.¹¹⁰ Then, of course, there is the aforementioned problem of the 10b5-1 plan, an SEC-sanctioned device that seems to undercut the SEC's own efforts to deter and punish insider trading.¹¹¹

Backstop ambiguity serves a valuable role in extending the enforceable spirit of a rule beyond its mere text. When the rule's spirit is unclear, however, open-ended standards will further muddy the waters, opening the floodgates of prosecutorial discretion and the risks that flow therefrom.¹¹² Thus, strong, clear norms are an essential predicate to effective backstop ambiguity.

IV. DESIGNING A SYSTEM WITH BACKSTOP AMBIGUITY

Part 0 takes the insights from the foregoing inquiry and offers a normative discussion for designing a system with backstop ambiguity. Section A begins by discussing factors to consider in determining when rules or standards would be more appropriate for addressing a given type of targeted conduct. Section B turns to regulatory considerations such as the size of sanctions and approaches to enforcement.

107. See, e.g., MACEY, *supra* note 4, at 248-49; Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Scientoer*, 52 U. KAN. L. REV. 147, 151 (2003) (describing recent SEC efforts to clarify the law of insider trading as “[i]ll-conceived and poorly constructed,” with “an oddly schizophrenic quality”).

108. See Donald C. Langevoort, “*Fine Distinctions*” in *the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 432 n.8 (2013) (noting “the never-ending debate among both lawyers and economists about whether and why insider trading is good or bad for the stock markets”). Compare George W. Dent, Jr., *Why Legalized Insider Trading Would Be A Disaster*, 38 DEL. J. CORP. L. 247, 248 (2013) (arguing that “the case for insider trading is insupportable” because “damage to public shareholders would far exceed any benefits from insider trading”), with David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1451 (1986) (arguing that the SEC’s ban on insider trading “is motivated by political rent seeking rather than a quest for economic efficiency”).

109. MACEY, *supra* note 4, at 241-42.

110. See generally Langevoort, *supra* note 108.

111. See *supra* notes 44-49 and accompanying text.

112. See *supra* notes 76-79 and accompanying text.

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

A. When to Use What: Rules vs. Standards

In general, regulators should be guided by the principle that the law should be spelled out in explicit language wherever possible, with backstop ambiguity serving only as a precaution against violations that are difficult to define or unforeseen at the time of drafting.¹¹³ Two additional factors may be relevant in determining the proper boundary between rules and standards in any given area: the identity of the potential victim and the magnitude of the potential harm.

1. The Identity of the Potential Victim

The financial industry includes a diverse cast of players, from high-powered investment banks and white-shoe law firms to public pension plans and individual investors. Regulators should not lose sight of the fact that these actors may have different motivations and, importantly, different levels of sophistication. Backstop ambiguity may be particularly appropriate where regulators expect to see a disparity in the sophistication between the parties, or where a broadly distributed public good is potentially at stake.

A transaction between two elite financial institutions proceeds most efficiently in an environment of low legal uncertainty.¹¹⁴ Both sides are equipped with the expertise and resources necessary to investigate the law, and each party can be expected to perform its own risk assessment of the proposed deal. For these types of transactions, characterized by mutual sophistication, bright-line rules facilitate efficient market contracting.¹¹⁵ However, there is still a role for ambiguous prohibitions on fraud in such contexts; the SEC's recent case against industry giant Goldman Sachs and Fabrice "Fab" Tourre, for example, concerned a transaction with other large financial institutions.¹¹⁶ The complaint did not target Goldman for proposing a bad deal, but rather for deliberately concealing an adverse party's role in structuring the transaction.¹¹⁷

113. See *supra* Part III.A.

114. See, e.g., Haag & Keller, *supra* note 92, at 203 ("[L]ack of clarity can delay beneficial refinancing transactions and, in some cases, prevent transactions from being completed.").

115. Cf. Davidoff et al., *supra* note 15, at 530 ("[S]ome investment banking deals are now transacted at arm's length and rely more upon formal contracts; we argue that, for this type of deal, there is a stronger case for legal rules regulating the investment bank counterparty relationship.").

116. See Complaint, SEC v. Goldman Sachs & Co., 790 F. Supp. 2d 147 (S.D.N.Y. 2011) (No. 10 Civ. 3229), 2010 WL 1508202.

117. See *id.* at 1-3. But see Davidoff et al., *supra* note 15, at 541-42 (questioning the fraud charge in this case because "there was a clear transactional component" to the deal and it "involved no information that was not somewhere in the public domain").

Transactions with an imbalance of sophistication or bargaining power may benefit from a more nuanced approach. Bright-line rules still have their place, but the sophisticated actor could attempt to exploit the other party's ignorance or weak position. Backstop ambiguity could help to deter such conduct, threatening sophisticated actors with contextualized enforcement that will look beyond the specific rules. Tender offers serve as a good example: the Williams Act was passed in response to coercive offers by potential acquirers who bullied shareholders into submission with tight deadlines, inadequate disclosures, and looming threats of retribution.¹¹⁸ As explained in Part III.C.1, the SEC's regulation of tender offers is largely composed of detailed rules. However, the SEC and the courts have preserved definitional ambiguity in the operative determination of whether a given situation constitutes a tender offer, thus preventing an end-run around the Williams Act through creatively designed but equally coercive solicitations.

Similarly, backstop ambiguity has a place where regulators are concerned about a public good, like the success of a whole industry or the nation's economic stability. Government bailouts may be deemed politically or economically necessary in certain instances, but such state assistance must not be so certain as to induce moral hazard in regulated entities. Commentators have discussed a policy of maintaining uncertainty in the process for determining government action in such instances in order to preserve market discipline on important financial institutions.¹¹⁹ In the same way, backstop ambiguity can apply more broadly to punish and deter conduct that regulators have not anticipated, but that strikes them as worrisome at a systemic level. Passing new statutes and promulgating new rules are lengthy processes; backstop ambiguity allows for a more nimble response.

2. The Magnitude of the Potential Harms

Rules and standards can be effective together or separately when the targeted conduct has the potential to produce large harms. A clear rule sends a clear signal about prohibited conduct. A standard manages to be expansive without necessarily being overinclusive, since regulators can drill down on the conduct they believe actually causes harm.¹²⁰ Consider, for instance, the SEC's rules on disclosures and fraud. Dishonest dealing can wreak massive economic damage; indeed, fraudulent conduct has been identified as a precipitating factor in the

118. See Davidoff, *supra* note 88, at 216-17 (explaining that the Williams Act was largely a response to coercive "Saturday Night Special" tender offers).

119. Note that commentators in this context refer to a policy of "constructive ambiguity." See *supra* note 65 and accompanying text.

120. See *supra* notes 67-70 and accompanying text; see also Diver, *supra* note 30, at 75 ("Where the costs of over- or under-inclusiveness are high, rational policymakers will favor highly flexible or intricate regulatory formulas.").

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

financial crisis.¹²¹ Securities laws include a byzantine array of specific disclosure requirements for public companies and participants in specific types of transactions,¹²² and these rules are all supported by the SEC's broad prohibition on any fraudulent or misleading activity "in connection with the purchase or sale of any security."¹²³

Of course, pursuing legal action under a vague standard can be time-consuming and expensive as compared to the predictable and efficient enforcement of bright-line rules.¹²⁴ Standard-based enforcement often involves extensive investigation, since standards demand a holistic assessment rather than a single strict-liability trigger. Enforcement may also require extensive litigation, since the parties will likely disagree on the standard's proper scope. Therefore, backstop ambiguity should only be used to regulate conduct with the potential to produce large harms. From an efficiency perspective, smaller harms are best regulated with bright-line rules because the costs of enforcement are much less likely to exceed to costs of unmitigated harmful conduct.¹²⁵

Because backstop ambiguity should only be used to prevent a large potential harm, it should be relatively straightforward to articulate a normative justification for the policies that target that harm. Defining and defending the purpose of a vague standard is not only important for political and democratic reasons, but also clarifies the goals of enforcement and avoids the problems of convoluted and inconsistent interpretation that we saw in the insider trading context.¹²⁶ By contrast, the Williams Act's regulation of tender offers remained cohesive and internally consistent in large part because regulators and courts had a clear sense of what the Act was trying to achieve: ensuring that shareholders of the target company were treated fairly and that they would be given enough information and enough time to make a proper decision.¹²⁷

121. See, e.g., Andrew Ross Sorkin, *Pulling Back the Curtain on Fraud Inquiries*, N.Y. TIMES DEALBOOK (Dec. 6, 2010, 8:59 PM), <http://dealbook.nytimes.com/2010/12/06/pulling-back-the-curtain-on-fraud-inquiries> (arguing that if the government had made a greater effort "to ferret out fraud at major companies . . . , we might have been able to stop the financial crisis, or at least we'd have a fighting chance at stopping the next one").

122. See generally *The Laws That Govern the Securities Industry*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/about/laws.shtml> (last visited January 15, 2014) (listing laws with disclosure requirements in settings like securities registration, proxy solicitations, tender offers, and investment relationships).

123. 17 C.F.R. § 240.10b-5 (2014).

124. See Park, *supra* note 33, at 119.

125. See Rose, *supra* note 28, at 2183-84 (discussing direct and indirect enforcement costs in the context of securities fraud).

126. See *supra* Part III.C.2.

127. See Charlene Wendy Christofilis, Note, *The Tender Offer: In Search of a Definition*, 43 WASH. & LEE L. REV. 901, 903 (1986).

B. Regulatory Considerations for a Backstop Ambiguity Regime

The following sections provide a number of recommendations for the design and enforcement of regulatory structures that include backstop ambiguity. First, penalties must be large enough to provide effective deterrence. This may require increasing statutory maximums and/or minimums, as well as reforming the SEC's habit of declining to seek admissions of guilt in settlement agreements. Second, regulators may be tempted to pursue individual defendants for political reasons or a sense of justice, but administrative resources are likely to be most effectively leveraged when the agency concentrates on institutional defendants. Third, both standards and rules must be consistently enforced if they are to effectively deter violative and evasive conduct. Fourth, the SEC must be vigilant in updating bright-line rules as necessary to account for shifting trends.

1. Magnitude of Sanctions

Backstop ambiguity provisions are meant to deter regulated entities from attempting to thwart regulatory goals with clever legal maneuvering. At their heart, they are meant to deter regulatory evasion. As such, they must do more than simply require violators to disgorge unjust profits or pay a nominal fine, since frequent violators would come out ahead as long as they managed to go uncaught at least some of the time.

The SEC is limited by maximum penalty amounts, which vary depending on the number of violations and the adjudicative venue.¹²⁸ In trials, courts have occasionally taken a restrictive approach to determining the number of discrete violations.¹²⁹ The agency has asked Congress to increase substantially its maximum limits,¹³⁰ and has resorted to settling many of its cases. The large settlement amounts reached recently seem to suggest an agreement based on multiple violations for each company, but the settled orders provide little insight into the basis for the final amount.¹³¹ The SEC maintains that its policy is to pursue

128. See Dorothy Heyl, *Be Careful What You Wish For—SEC Penalties Act and “Southern Union,”* MONDAQ (Jan. 3, 2013), <http://www.mondaq.com/unitedstates/x/213716/Securities/Be+Careful+What+You+Wish+For+SEC+Penalties+Act+And+Southern+Union> (reviewing the SEC's maximum penalty amounts).

129. See Theodore A. Levine et al., *SEC Penalties: Getting Tougher, and Remembering Some History*, WACHTELL, LIPTON, ROSEN & KATZ (Oct. 17, 2013), http://www.wlrk.com/docs/SEC_Penalties_Getting%20Tougher_and_Remembering_Some_History.pdf (discussing *In re Reserve Fund Sec. & Derivative Litig.*, No. 09 Civ. 4346, 2013 WL 5432334 (S.D.N.Y. Sept. 30, 2013)).

130. See Henning, *supra* note 2.

131. See Heyl, *supra* note 128.

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

settlement only where “the settlement agreement is within the range of outcomes we reasonably can expect if we litigate through trial.”¹³²

Judge Rakoff of the Southern District of New York has criticized the SEC’s habit of proposing settlements with no admission of wrongdoing, arguing that “a consent judgment that does not involve any admissions and that results in only very modest penalties is just as frequently viewed . . . as a cost of doing business” rather than a real punishment.¹³³ Judge Rakoff had begun rejecting some of the SEC’s proposed settlements,¹³⁴ but the Second Circuit intervened in June 2014, declaring that “[t]he primary focus of [a district court’s] inquiry . . . should be on ensuring the consent decree is *procedurally* proper, . . . taking care not to infringe on the S.E.C.’s discretionary authority to settle on a particular set of terms.”¹³⁵ In the meantime, the SEC announced a new policy precluding “neither admit nor deny” settlements in “the minority of . . . cases where there is a parallel criminal conviction . . . that overlap[s] to some degree” with the SEC’s civil suit.¹³⁶

For the SEC to pursue an effective strategy of backstop ambiguity, it would need to seek penalties large enough to serve as an effective deterrent. This could be achieved through higher penalty limits, or through an aggressive policy of seeking admissions of guilt (even where there is no parallel criminal conviction).

132. *Examining the Settlement Practices of U.S. Financial Regulators: Hearing Before the H. Comm. on Fin. Servs.*, 112th Cong. 75 (2012) (statement of Robert Khuzami, Director, Div. of Enforcement, U.S. Sec. & Exch. Comm’n).

133. SEC v. Citigroup Global Markets Inc., 827 F. Supp. 2d 328, 333 (S.D.N.Y. 2011) *rev’d*, 752 F.3d 285 (2d Cir. 2014). See generally Daniel T. Hubbell, Note, *Judge Rakoff v. the Securities and Exchange Commission: Are “Neither Admit Nor Deny” Settlement Agreements in Securities Cases in the Public Interest?*, 15 TRANSACTIONS: TENN. J. BUS. L. 373, 395-408 (2013) (describing several Judge Rakoff opinions that assessed consent judgments).

134. See Ben Protess & Matthew Goldstein, *Overruled, Judge Still Left Mark a Mark on S.E.C. Agenda*, N.Y. TIMES DEALBOOK (June 4, 2014, 10:58 AM), <http://dealbook.nytimes.com/2014/06/04/appeals-court-overturns-decision-to-reject-s-e-c-citigroup-settlement>.

135. SEC v. Citigroup Global Markets, Inc., 752 F.3d 285, 295 (2d Cir. 2014) (emphasis added). Beyond this primary inquiry, “[a] court evaluating a proposed S.E.C. consent decree for fairness and reasonableness should, at a minimum, assess (1) the basic legality of the decree; (2) whether the terms of the decree, including its enforcement mechanism, are clear; (3) whether the consent decree reflects a resolution of the actual claims in the complaint; and (4) whether the consent decree is tainted by improper collusion or corruption of some kind.” *Id.* at 294-95 (internal citations omitted).

136. Public Statement, Robert Khuzami, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm’n., Public Statement by SEC Staff: Recent Policy Change, SEC (Jan. 7, 2012), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171489600#.U-Gul4BdXuE>.

tion), which would permit follow-on private suits to claim issue preclusion¹³⁷ and stack their damages on top of the SEC's penalties. These recommendations for invigorated enforcement may seem unrealistic to those who accuse the SEC of regulatory capture.¹³⁸ However, landmark settlement awards following the financial crisis¹³⁹ suggest that the SEC will at least respond to political pressure. If regulatory capture remains a concern for sufficiently aggressive penalties, Congress could always consider raising the statutory minimums.

2. Who to Sue? Individual vs. Institutional Defendants

The question of whether to target individuals or institutions presents a conflict between ideals and pragmatics. Holding individuals accountable for their actions may bolster the deterrent effect of SEC enforcement and fulfill societal notions of justice by punishing the people who were directly responsible for the alleged misconduct. Unfortunately, cases against individuals also tend to be more difficult to prove and more costly to pursue. Individuals are far more willing to go to court to defend their name than financial institutions, whose interests are best served by settling the matter quickly, getting it out of the press, and avoiding expensive court costs and attorney fees.¹⁴⁰

Given the SEC's limited resources, the more prudent strategy would be to prioritize the efficient disposition of high-penalty institutional settlements over lengthy investigations of fiercely combative individual defendants.¹⁴¹ Nonetheless, the SEC has faced public criticism for this approach, and the agency has promised to shift course and pursue more individual cases as it moves forward.¹⁴²

137. See Becker, *supra* note 5, at 1865; see also Hubbell, *supra* note 133, at 429 (proposing a new requirement for victim impact statements in SEC civil actions to help assess damages, humanize the human costs of misconduct, and provide closure to the victims). *But see* Khuzami, *supra* note 132 (arguing that “neither admit nor deny” settlements are both “common” and “sound public policy”).

138. See *supra* text accompanying note 83.

139. See notes 1-3, *supra*, and accompanying text.

140. See Becker, *supra* note 5, at 1862 (explaining why “individuals are less likely to settle cases than corporate entities”).

141. See *id.* at 1869 (noting that SEC enforcement “is an exercise in triage,” so the agency must make decisions about what kinds of case to prioritize); see also *id.* at 1862 (noting that “it is harder to prove a case against individuals than against entities”); Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 BUS. LAW. 679, 703 (2012) (discussing factors that “might prevent regulators from pinpointing individual actors as culpable”).

142. See Stuart Pfeifer, *SEC Chief Says Enforcement Will Target Individuals' Misconduct First*, L.A. TIMES (Sept. 26, 2013), <http://articles.latimes.com/2013/sep/26/business/la-fi-mo-sec-must-target-individuals-as-well-as-companies-white-says-20130926>; see also Gadinis, *supra* note 141, at 728 (“[W]hen big firms and their

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

Some commentators have also criticized the SEC's large institutional settlement amounts on the grounds that the money comes from corporate funds, and therefore only hurts shareholders.¹⁴³ The descriptive point is accurate, but the concern is misplaced: this connection to the shareholders is a critical component of the regulatory regime's deterrent effect. Given the difficulty of successfully prosecuting individual corporate executives, the only alternative is to hit them where it hurts: shareholder value. This creates an incentive for investors to choose companies that are less likely to be targeted for expensive enforcement, and also incentivizes efforts by officers and boards of directors to establish internal controls that deter and monitor ethical lapses among employees.¹⁴⁴ Indeed, some scholars have even proposed that corporations consciously attempt to cultivate "shareholder stewards" who will use their authority in responsible ways to promote the long-term health of the company.¹⁴⁵

In any case, shareholders would be the ones to benefit from inflated company profits if lucrative misconduct were to go unpunished. Shareholders are the residual risk bearers of the enterprise, and must take the good with the bad. In a regulatory environment of backstop ambiguity, shareholders may adjust their investment choices to reflect the possibility of large penalties for risky behavior, further bolstering the deterrent effect of the precautionary vague provision.

3. Consistency of Enforcement

Of course, for a penalty to serve as a deterrent, there must be a credible threat of its application against regulated entities that violate the law.¹⁴⁶ This certainly applies to backstop ambiguity provisions, which will only deter regulatory evasion if would-be evaders actually fear punishment. Consistency may be

staff were engaged in misconduct, the SEC often brought actions based exclusively on corporate liability, without naming any specific individuals as defendants.").

143. See, e.g., Becker, *supra* note 5, at 1856 ("Huge penalties were said to be particularly unfair to corporations, because their cost was borne by their shareholders, who . . . in cases of disclosure violations, were themselves the ones defrauded."); Andrew Ross Sorkin, *As JPMorgan Settles Up, Shareholders Are Hit Anew*, N.Y. TIMES DEALBOOK (Sept. 23, 2013, 8:58 PM), <http://dealbook.nytimes.com/2013/09/23/as-jpmorgan-settles-up-shareholders-are-hit-anew> (arguing that a settlement against JPMorgan Chase was paid by the "same shareholders who were ostensibly the victims of the scandal that already cost them \$6 billion," meaning that they were "victimized twice").
144. See *infra* notes 152-65 and accompanying text for further discussion of corporate leaders' role in creating a "culture of compliance."
145. See, e.g., Tamara C. Belinfanti, *Shareholder Cultivation and New Governance*, 38 DEL. J. CORP. L. 789 (2013).
146. See Park, *supra* note 33, at 141 (observing that only if the law is consistently enforced will "industry participants . . . be prompted to act preemptively in assessing their conduct").

challenging to assess with regard to a purposely ambiguous standard, particularly when regulators are testing out novel theories to target novel types of misconduct. In the end, good-faith efforts by regulators to preserve fairness in each case and to conduct evenhanded investigations may help to mitigate perceived inconsistencies in enforcement.

This principle is not limited to standards, however; the need for consistent enforcement also applies to bright-line rules. Enforcement actions focused on straightforward procedural violations are an important part of an effective regulatory regime. Former SEC General Counsel David Becker refers to these types of actions as “control cases,” and laments that they “do not command the same level of sanctions or notoriety as fraud cases.”¹⁴⁷ Indeed, the SEC “rarely brings control cases absent some other violation,” such as “fraud or a violation of the Foreign Corrupt Practices Act.”¹⁴⁸ This is a profound mistake, since prophylactic rules are the primary bulwark against misconduct. Part of the problem may be that regulators are simply understaffed and underfunded.¹⁴⁹ More cynical commenters may point to such enforcement lapses as evidence of regulatory capture.

As explained in this Note, ambiguous provisions should *supplement* the rules, not overshadow them. Penalizing minor infractions deters routine carelessness and mild fudging on the part of regulated entities, complacent attitudes that can escalate into more problematic behavior.¹⁵⁰ Such investigations are also important because small procedural violations are occasionally the signal of a much larger problem. The Bernie Madoff Ponzi scheme, for example, could have been detected much earlier had the SEC followed up on multiple hints of minor misconduct that were brought to its attention.¹⁵¹

4. Keeping Up with the Times

Finally, the SEC must ensure that its bright-line rules are periodically adjusted to remain current. Backstop ambiguity permits regulators the flexibility necessary to target unanticipated wrongdoing, but newly discovered violations should be described in guidance documents and codified in rules as soon as their scope can be effectively articulated. The tender offer overview in Part III.C.1 serves as a warning that even a well-designed system of backstop ambigu-

147. Becker, *supra* note 5, at 1878.

148. *Id.*

149. See Ford, *supra* note 53, at 261 (“[R]egulators need to have the necessary capacity in terms of numbers, access to information, expertise, and perspective to act as an effective counterweight to industry as the content of principles is developed.”). Ford discusses regulatory capacity in more detail. See *id.* at 289-93.

150. See *infra* note 161 and accompanying text.

151. See MACEY, *supra* note 4, at 220-21.

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

ity can eventually grow cumbersome if it becomes laden with rusty regulatory relics and confusing layers of informal policy.

CONCLUSION: THE RETURN OF REPUTATION?

As the importance of corporate reputation in the financial sector has declined, the SEC has developed a habit of “suing all industry participants” under vague standards for shared habits of alleged misconduct.¹⁵² The resulting settlements can be quite large,¹⁵³ but may result from violations by a small number of individuals.¹⁵⁴ This approach to rulemaking and enforcement has elements of backstop ambiguity, albeit with structural and procedural flaws that undermine its efficacy.¹⁵⁵ Nonetheless, these factors align to create an incentive for companies to steer well clear of the halo of ambiguity surrounding the SEC’s bright-line rules, and to cultivate this attitude in all employees along the command hierarchy. Companies should respond by developing a true culture of compliance and investing in their own homegrown monitoring schemes.

It is important to recognize that much of the misconduct targeted for enforcement may not necessarily be due to malicious bad-faith acts by greedy bankers.¹⁵⁶ Findings from behavioral psychology show that rational and well-intentioned people can fall prey to the pernicious effects of chronic underestimation of risk and overestimation of compliance, especially when those self-serving biases are reinforced by internal feedback loops within the company.¹⁵⁷ Corporate executives play a vital role in setting the proper tone for developing a culture of compliance.¹⁵⁸ Former SEC Chair William H. Donaldson exhorts boards of directors to “look beyond the letter of the law and be ever mindful of

152. *Id.* at 235.

153. *See supra* notes 3, 6, and accompanying text.

154. *See, e.g.,* Complaint, *supra* note 116 (noting that Goldman employee “Tourre was principally responsible for” the synthetic credit default swap at issue in the case).

155. *See supra* Part III.C; *see also supra* Part IV (making recommendations for improved securities regulation in a backstop ambiguity paradigm).

156. *See* Miriam H. Baer, *Confronting the Two Faces of Corporate Fraud*, 66 FLA. L. REV. 87, 121-24 (2014) (describing a typology of employees involving the axes of well-motivated/opportunistic and time-consistent/time-inconsistent); Becker, *supra* note 5, at 1888 (explaining that in his experience as a white collar defense attorney, few individuals targeted by the SEC “genuinely believe that they have behaved badly”).

157. *See* Ford, *supra* note 42, at 618 (noting that industry actors “may be inclined, as part of an adaptive bias within the firm toward overconfidence and over-optimism, to overestimate the degree of their own compliance, competence, and knowledge”). *See generally* Langevoort, *supra* note 23 (discussing the behavioral psychology of institutional risk perception).

158. *See id.* at 1241 n.144 (“There is a substantial literature on the psychology of CEO’s and its influence on corporate decision making and performance.”).

the spirit of the reforms” in order to “build[] a corporate culture based on a philosophy of high ethical standards and accountability.”¹⁵⁹

A culture of compliance must be generated at the top with strong leadership,¹⁶⁰ but it must be maintained at the bottom with strict adherence to prophylactic rules with hardline requirements. “[A] major significance of controls is the almost mechanical sense in which they prevent inappropriate conduct” by mandating certain disclosures or procedures, but they also play a vital role as “the mechanisms through which culture begets conduct.”¹⁶¹ A lackadaisical attitude toward small lapses may well escalate into a broader complacency over compliance, with dangerous repercussions for the behavioral psychology of individual risk assessment. If industry actors are not careful about adhering to straightforward rules, they are much less likely to be careful in the gray zone of backstop ambiguity beyond the rules.

Corporate leaders must also think carefully about their internal systems of monitoring and feedback, a set of practices that has been analogized to a “corporate immune system” with a “range of internal mechanisms to ward off threats.”¹⁶² Boards have a fiduciary duty to monitor for illegal conduct, but the monitoring system need only comport with the minimally adequate standard of the business judgment rule.¹⁶³ Increasingly rigorous federal monitoring requirements have largely supplanted this state law duty,¹⁶⁴ and academics have

159. William H. Donaldson, Chairman, U.S. Sec. & Exch. Comm’n, Remarks Before the Economic Club of New York (May 8, 2003), <http://www.sec.gov/news/speech/spch050803whd.htm>.

160. See, e.g., Dan Awrey et al., *Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?*, 38 DEL. J. CORP. L. 191 (2013). Awrey et al. discuss the importance of an “ethical culture” in finance, and propose mechanisms for promoting such a culture including a board-level ethics committee, *see id.* at 232-34, and remuneration reforms all along the hierarchy of command, *see id.* at 234-38.

A different set of considerations pertains to the proper placement and function of a compliance department. See, e.g., Michele DeStefano, *Creating a Culture of Compliance: Why Departmentalization May Not Be the Answer*, 10 HASTINGS BUS. L.J. 71 (2014) (arguing “departmentalizing” compliance departments by removing them from the general counsel’s office is a counterproductive step in the effort to produce a “culture of compliance,” and discussing the various ways that ethical decision making is affected by structures and psychological tendencies independent of top-down management).

161. Becker, *supra* note 5, at 1879-80.

162. Omari Scott Simmons, *The Corporate Immune System: Governance from the Inside Out*, 2013 U. ILL. L. REV. 1131, 1133 (2013).

163. See *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (“[T]he level of detail that is appropriate for [a compliance] information system is a question of business judgment.”).

164. See Mercer Bullard, *Caremark’s Irrelevance*, 10 BERKELEY BUS. L.J. 15, 23 (2013) (“[F]ederal regulatory law is a far more determinative source of law than *Care-*

BACKSTOP AMBIGUITY: A PROPOSAL FOR BALANCING SPECIFICITY AND AMBIGUITY

vigorously debated the question of whether the burdensome costs of these detailed compliance regimes outweigh the benefits.¹⁶⁵ Companies must adhere to federal law, but should make an effort to proactively assess their own monitoring programs and how they will affect employees' conduct. Feedback loops are important: employees should be acknowledged for making decisions to prioritize ethical standards over short-term gain, and should be admonished for unjustifiably risky decisions even if they turned out to be profitable.

At the moment, the financial industry is held in exceedingly low public esteem and is battling a wave of high-profile enforcement actions. Corporate leaders could resignedly accept that this is the new normal, or they could choose to respond, attempting to recapture the lost sense of pride in working at a company known for fair dealing and putting the needs of clients first. Regulators, for their part, should address flaws in regulatory design and enforcement tactics in order to maximize the deterrent effects of a backstop ambiguity regime. It may be too much to ask for such strong good-faith efforts from an industry accused of deep-seated greed and an agency dismissed as hopelessly captured by political machinations and private interests. Then again, reputation building is a long road. A reputation is simply the reflection of aggregated decisions over time, and it is never too late to shift course and start moving in a new direction.

mark in the design and operation of corporate compliance systems.”). The Sarbanes-Oxley Act of 2002, for example, contains “provisions that require independent audit committees, restrict corporations’ purchases of nonauditing services from their auditors, prohibit corporate loans to officers, and require executive certification of financial statements.” Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1527 (2005); see also Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

165. See, e.g., Susan M. Gates & Kristin J. Leuschner, *Do the Benefits of Sarbanes-Oxley Justify the Costs? Empirical Evidence in the Case of Small Firms*, KAUFFMAN-RAND INST. FOR ENTREPRENEURSHIP PUB. POL’Y (2007), http://www.rand.org/content/dam/rand/pubs/research_briefs/2007/RAND_RB9295.pdf (finding that the available evidence includes a “mixture of negative and positive effects on small firms”).