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THE REGULATOR IN A DEREGULATORY ERA

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Today I would like to read you a brief, but revealing, passage from a critique of the SEC recently published by Nicholas Wolfson, a law professor, co-author of a widely-read treatise on broker-dealer regulation, and a former SEC staffer:

> Those few SEC attorneys in positions of power who enter the agency with a determination to decrease regulation face immense psychological pressures to change their ways. Bureaucratic rewards are based upon excellence, speed, and facility in producing new regulations. A conservative who works at the SEC will quickly realize that the work expected of him or her is the drafting of these new and additional regulations. The SEC attorney who balks at this process and produces less regulation is quickly identified as an iconoclast, or worse, an enemy of the agency esprit de corps. His "in box" empties, he is no longer invited to meetings, and ultimately he is revealed to the press by his colleagues as an obstructionist.*

To give Wolfson his due, there are two ways in which his criticism could be interpreted. He might be saying that there is an institutional bias, inherent in our regulatory structure -- or perhaps in all regulatory structures -- that creates the kind of "pro-regulation" climate he describes. An alternative interpretation, one I am reluctant to make, is that Wolfson is not attacking the nature of the structure, but the integrity of the individuals who function within it. If this is in fact what he means, he reveals a degree of hostility and cynicism that is nothing short of astonishing.

I am not sure which of these two constructions to place on Professor Wolfson's critique. In either case I believe him to be demonstrably wrong. But what is even more important is that, whatever his own intention, there appear to be large numbers of auditors, both close observers of government and ordinary citizens, who are ready -- indeed eager -- to take his remarks in the second, cynical sense. And these sentiments need not be confined to one agency. Wolfson's attack can be turned on others as well. While Professor Wolfson's attack may be singular in the depth of its cynicism, his is not the only voice being raised against the SEC and the other regulatory agencies of Government.

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* Wolfson, A Critique of the Securities and Exchange Commission, 30 Emory L. J. 119, 126 (1981) (emphasis added).

The views expressed in this paper are my own and do not necessarily represent those of the Commission, my fellow Commissioners, or the staff.

Recent years bear witness to many challenges to the basic assumptions on which our governmental administrative structure is founded. And in response to the critics, Congress and the Executive Branch have sought to rein in the regulators. Whether under the banner of "regulatory reform," or "deregulation" or "getting the government off the backs of the people," the message for us is the same: You have abused your discretion, exceeded your authority, excessively burdened the people and lost their trust and confidence. You had best shape up, tend to your knitting and do it more effectively . . . or else.

Could these views be correct? Even if these challenges are not supportable, the very fact that such a misperception can gain currency is itself disturbing, because no governmental structure can long survive without the confidence and support of the people affected.

Most observers would agree that, over the past two decades, there evolved a growing lack of confidence in our governmental institutions. Today, I would like to share with you some observations concerning this development, since the lack of public confidence and trust, and what it has spawned by way of reform measures affecting our daily work, has been one of the sharpest surprises of my half-year at the Commission.

As one born in the Depression, I was well aware of the original flowering of economic regulation with the New Deal, and its growing acceptance during the regulatory honeymoon of the next few decades. As a practicing lawyer, I was also familiar with the explosion of law and regulation from the mid-60's through the mid-70's, and the resulting discomfort that grew over the central and costly role that regulators were playing in the governance of our society. Indeed, as a securities lawyer, I was often confronted with what appeared to be the ever-expanding regulatory reach of the SEC. And, of course, I was aware of the important and timely reaction to the regulatory explosion, resulting in a reassessment of the role of government regulation and a push for deregulation.

What I did not know, when I started with the Commission, was the degree to which Congress had actually responded to the problem by, in effect, regulating the regulators.

Regulating the Regulators

In fact, today there is a tightly woven fence around the SEC and most other regulatory agencies -- a fence that constrains most agency procedures and subjects numerous agency decisions to outside controls. The new statutes which thus regulate the regulators all have admirable purposes. They fall into three general categories: those designed to increase the openness and accountability of government (by far the largest group), those designed to limit the power of agencies vis a vis individual members of the public, and those designed to achieve specific, deregulatory goals. Let me briefly mention the major statutes in these areas. There are eight of them, not counting the Administrative Procedure Act -- the 35-year-old grandfather of regulatory reform. As you all know, that Act prescribed minimum procedural requirements for regulatory agencies in two areas -- rulemaking and adjudication. Most commentators believe the APA has worn well, as a flexible and modest approach to agency accountability.

Legislation Promoting Accountability. The first major addition to the APA in the area of accountability was the Federal Advisory Committee Act, passed in 1972. This legislation was aimed at preventing agencies from consulting in private with groups of interested parties before a formal rulemaking proceeding began and the APA became applicable. It requires that each advisory committee be formally chartered by an agency, that meetings with the committee be held in public and that the committee be fairly representative of all affected parties in the private sector.

In 1974, Congress enacted far-reaching amendments to the 1966 legislation known as the Freedom of Information Act and, in addition, passed a new complementary statute known as the Privacy Act. These laws define the public's right to gain access to information held by a government agency. Subject to a number of exceptions, the FOIA establishes the public's right to acquire information about any topic of interest. The Privacy Act regulates the procedure by which an individual can request information specifically relating to him on file with an agency and requires the agency to indicate the uses it will make of the information. The purpose of those two Acts is to foster accountability by making agency records available to the public.

Finally, in 1976, the Government In the Sunshine Act became law. This Act was designed to promote accountability by making agency decisionmaking more visible. It established a presumption that the public is entitled to attend any meeting of a regulatory agency at which decisions will be made, unless special circumstances warrant confidentiality.

Legislation Promoting Individual Rights. This category of laws exhibits an attempt to correct imbalances when an agency is in conflict with a private citizen or small company. The Right to Financial Privacy Act, passed in 1978, specifies notice and other procedures which must be followed before a governmental agency may obtain access to the financial records of an individual held by a bank or other financial institution. More recently, the Equal Access to Justice Act, which became law in 1980, provides for the payment of counsel fees to individuals and small companies who prevail in litigation against a federal agency, if the agency's legal position is not "substantially justified."

Deregulatory Legislation. This category includes legislation designed to compel agencies to take specified procedural steps in pursuit of the goal of deregulation. The Regulatory Flexibility Act, a 1980 statute designed to promote the capital needs of small business by reducing their regulatory burdens, requires each agency to consider whether its rules would have a "significant economic impact on a substantial number of small business entities." Unless the agency head can certify that there will be no such impact, the agency must prepare and publish special economic analyses of the effects of each new rule on small entities. This law also requires the Small Business Administration to act as a consultant for each agency on the needs of small businesses and requires a periodic review of all existing rules in light of small business needs. The approach of the Regulatory Flexibility Act would be extended more generally in the proposed Regulatory Reform Act, now being considered by Congress. Under this proposed law, all agencies would be required to perform a cost-benefit analysis on proposed rules projected to have an annual effect of $100 million or more on the economy.

In 1980, Congress also passed the Paperwork Reduction Act, which requires each agency to submit its forms to and obtain clearance from the Office of Management and Budget before engaging in the collection of any information from the public. The purpose of this legislation is to reduce duplicative information requests from government agencies and generally to alleviate the paperwork burdens on the private sector.

I should also mention, in a category by itself, the 1978 Ethics in Government Act. This legislation, which is designed to promote fairness and objectivity in agency decisionmaking, requires substantial financial disclosures by government officials and employees and bars certain private sector employment to individuals for various periods after they leave government service. While not a direct limitation on the agencies, this legislation, along with federal criminal and other legislation barring conflicts of interest, can have a substantial impact on the actions of agency personnel.

Regulatory Burdens

I have no quarrel with the goals of any of these statutes. To the contrary, each is rooted in laudable purposes aimed at curing recognized problems. And who could reasonably argue that government ought to be burdensome, inefficient, or unfair. Rather, my point is that, precisely in the way that regulation of the private sector exacts costs and imposes burdens that should be weighed carefully against the intended benefits, regulating the regulators in an effort to do something about the public's distrust of its public servants also involves costs. Agency action is made less efficient and more expensive. To the extent that agencies are performing public services -- and being an optimist I trust that they are -- those services are rendered more dear. Of course, there is a trade-off here. But, looked at in their totality, the benefits of these laws may at some point be outweighed by their costs.

These costs may, in some cases, be higher than necessary. The SEC's experience with many of these laws suggests that they are often used in ways that the Congress never intended -- or they have unanticipated negative effects -- that magnify their burdens. For example:

-- We have found that requests for information under the Freedom of Information Act are most often efforts to uncover information about business competitors, or to assist in the prosecution of private law suits, or to uncover the Commission's investigative files. Far less often is information requested for the statutory goal of learning about the workings of government.

-- Under the Sunshine Act, some have suggested that three or more SEC Commissioners may not even be able to have lunch together, in private, unless they rigidly avoid any discussion of Commission business. Clearly, the law has the unintended effect of sharply impairing the free, open and uninhibited exchange of ideas among a collegial body which promotes sound decisionmaking, the very purpose of providing for a collegial body, rather than a single head, to run an agency. Of course, this law does not apply at all to single-headed agencies.

-- The effort expended at the SEC to comply with the Paperwork Reduction Act -- about 35 staff years in 1981 alone -- has delayed the Commission's own internal program to alleviate the regulatory burdens on small businesses and simplify compliance for all regulated entities.

-- The apparent reach of the Federal Advisory Committee Act, coupled with the burdens of meeting the requirements of the Act in setting up advisory committees have made it significantly more difficult for the Commission to obtain informal comment and advice from private sector sources.

When all the costs are totalled, the results can be significant. We have estimated that 50 to 70 staff years are devoted annually to matters outside the Commission's primary statutory mandates. This is the equivalent of 10% of the SEC's professional headquarters effort.

Congress has been criticized for its actions in the late 60's and early 70's which resulted in "hurling a law" at each new problem in society, often, some have argued, without careful analysis of costs and benefits. Likewise, the regulators have been accused of believing that all problems could be solved through regulation -- that the more detailed the system, the better the result.

Driven by what I might call America's crushing love affair with fairness, the laws and regulations written in this period caused the system to tilt. The benefits -- abundant in theory -- failed to materialize, while hidden costs unduly burdened the private sector. The public was jilted.

Now, it seems this problem may be repeated in a laudable effort to retrieve public confidence and trust. It would be a pity, having recognized that considerations of cost must be carefully weighed before regulatory solutions are applied to private sector problems, to ignore that lesson in seeking to use regulatory solutions to solve governmental shortcomings.

I suggest that the burdens imposed by the web of regulation surrounding our administrative agencies be carefully examined by Congress, and the aggregate effects be taken into account in planning future regulatory reform. This might best be accomplished by a formal study of the direct and indirect costs of regulating the regulators, perhaps undertaken by the General Accounting Office or the Administrative Conference of the United States.*

In looking back at the regulatory excesses of the late 60's and early 70's, I do not mean to overstate the responsibility of either the Congress or the Executive Branch. As regulators, we were closer to the expansion process than any one else, and we must, therefore, bear our fair share of responsibility for permitting the system to grow so luxuriantly. There was another way. I believe tighter and more forwardlooking administration of the regulatory agencies at the critical junctures might have lessened these problems. Further, I believe that future excellence in regulation may yet restore a measure of the confidence which has been lost over the past 15 years. It is to that general topic I would now like to turn.

Responsibility in Regulation

What is good regulation? I feel it is the least regulation necessary to achieve the statutory goal. Regulators should hold a bias favoring the less restrictive regulatory solution, or the non-regulatory solution. They should have a procompetitive bent.

The task of the good regulator does not end when initial solutions are proposed to existing regulatory problems. Once a regulatory structure responsive to Congressional goals is in place, a significant proportion of the energies of the effective regulator should be devoted to the continuing

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* In this regard it is interesting to note that Senators Roth and Eagleton, on January 5, 1981, introduced a bill (S.10) to establish a Commission on More Effective Government, with the declared objective of improving the quality of government in the United States and of restoring public confidence in government at all levels.

process of internal re-evaluation. Regulators should be alert to indications that the existing regulatory approach is defective -- whether because the underlying problems have changed, the rules do not work as predicted, or even due to the emergence of unanticipated regulatory burdens which outweigh the desired benefits. I believe that it is only by demonstrating that they have the ability to uncover and repair regulatory problems themselves, that the agencies will be able to convince the Congress, the Executive Branch and the public generally that they are responsible enough to deserve the power that they have been given, without unusual or draconian restraints on their discretion.

Unfortunately, not many would express confidence in the ability of agencies to achieve the level of self-renewal I am suggesting is necessary. On the other hand, given the regulatory excesses we have witnessed, probably not many would agree with John Kenneth Galbraith's somewhat jocular assessment of an agency's life cycle. In 1955, he wrote:

> Regulatory bodies, like the people who comprise them, have a marked life cycle. In youth, they are vigorous, aggressive evangelistic and even intolerant. Later they mellow, and in old age -- after a matter of ten or fifteen years -- they become, with some exceptions, either an arm of the industry they are regulating or senile.*

After almost half a century, the SEC is still alert enough to recognize the dangers of co-option and senility, as well as the importance and challenge of self-renewal. And we are grappling with these problems. Errors we have made in the past, and no doubt they will occur in the future. But we are trying to learn from our mistakes. Without meaning to suggest that the SEC is in any sense a model agency (but rather the only one to which my half-year of government service relates), let me describe several instances where we have engaged in the re-evaluation process in ways that I feel proud enough about to relate here. They may reveal something of how the Commission is functioning under John Shad's leadership.

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* Galbraith, The Great Crash 171 (Houghton Mifflin, 1955).

Integration. Within the next few weeks, the SEC will complete the major portion of a two-year effort to integrate the requirements of the Securities Act of 1933, which focuses on the initial offering of securities, and the Securities Exchange Act of 1934, which emphasizes ongoing public reporting. Some may criticize the Commission for taking so many years to implement this notion, particularly given the intellectual underpinning it received from the Commission's 1963 Report of Special Study of Securities Markets, and Milton Cohen's 1966 law review article "Truth in Securities" Revisited. Nevertheless, I believe the Commission's staff performed an immensely valuable function by re-examining all of the disclosure items in both major statutes and continually asking itself the difficult question: How can the statutory goal of disclosure be achieved to a satisfactory degree with the greatest efficiency and the least cost, while maintaining investor protection and the integrity of the markets? The result is a detailed revision, streamlining and combining many divergent disclosure rules into one intelligent system that elicits the required information in a coherent and cost-conscious manner.

Regulation D. Another, related rationalization of separate regulatory systems is the effort currently proceeding, under the name "Regulation D," to codify and simplify certain of the many different exemptions from registration under the Securities Act of 1933. Prior to this effort, there were a number of separate exemptions, applying to different situations in different ways. Beyond bringing order to the Commission's own provisions, the staff has undertaken, in cooperation with the North American Securities Administrators Association, to design a single uniform exemption applicable to offerings of less than $5 million, under both federal and state securities laws. This effort, when completed, should result in substantial savings of time and money in the multi-state offering of securities.

Public Utility Holding Company Act of 1935. On a regular basis, we are trying to take a fresh look at existing regulatory structures to determine whether changes in the marketplace since their enactment or other factors may have changed the assumptions upon which they were originally based. The Congress is now doing just that in the case of Glass-Steagall. And we have recently done it with the Public Utility Holding Company Act of 1935. As you may know, we have recommended to the Congress that the Act be repealed.

The purpose of the 1935 statute was to simplify the complex financial structures of the post-depression utility holding companies, and thereby to eliminate the opportunity for manipulation and deception which these structures had created. By the 1950's, the major portion of this job had been completed, and today the increased sophistication of the financial markets, as well as the greatly improved disclosure requirements of the remaining federal securities laws, make a recurrence of the problems which prompted the 1935 statute highly unlikely.

This result may come as a shock to Professor Wolfson. In a _bravado_ display of economic analysis misapplied, he wrote:

> SEC attorneys make their living interpreting laws and regulations. Attorneys who seek to maximize their utility as employees, therefore, will always add to regulation rather than decrease it. *

Investment Advisers Act of 1940. Another example of re-evaluation is the current study of the Investment Advisers Act of 1940 by the Commission's Division of Investment Management. While I have no advance knowledge of the results of that study, I can easily see it producing recommendations for lesser regulation in certain respects and greater regulation in others. Except in limited cases, the Advisers Act prohibits advisory fees based on capital gains or capital appreciation. One can make a strong case that this prohibition is not necessary in the public interest and, indeed, is counterproductive. The argument would be that fee restrictions of this sort deny the public access to those managers who insist on incentive fees and stifle efforts to shape incentives to foster better performance -- all without offsetting benefits. Disclosure should suffice, together with the flexible antifraud provisions already in place.

On the other hand, it has always struck me as incongruous that broker-dealers, and their registered representatives, whose business often includes giving investment advice to clients, are subject to stringent educational and other qualifications, while investment advisers -- performing much the same function -- remain wholly unregulated in these respects. I strongly suspect a poll would reveal that the investing public thinks

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* Wolfson, _supra_, at 126.

of investment advisers as the pros -- the MBAs -- with special qualifications and professional standards setting them apart from mere brokers. Registration as an investment adviser may carry just such an imprimatur to the public. Yet there is nothing in the law or regulations to support these assumptions. Indeed, the qualifications and professional standards required of brokers by the SEC and the self regulatory organizations turn those assumptions on their heads.

There is little to recommend this disparity, which could be corrected by bringing advisers under a somewhat similar regulatory scheme to that now applicable to broker-dealers. It is interesting to note that the ALI Federal Securities Code would do just that.

Of course, the point here is not to debate the Public Utility Holding Company Act or the Investment Advisers Act. Rather, what I am trying to emphasize is the importance of a continual process of questioning the current validity of our regulatory structures in light of all relevant developments; and of acting to adjust those structures to improve their effectiveness, or eliminate them when they are found to serve no further useful purpose.

The Internalization Problem. In connection with its lengthy efforts to develop a national market system for trading in securities, the SEC recently issued an order requiring major over-the-counter and exchange markets to be electronically linked with regard to transactions in approximately 30 specified securities. One of the objections to this order for linkage was that the Commission had not promulgated a protective rule which would require large securities firms to expose their customers' orders to other participants in the marketplace before filling those orders themselves.

The concerns were two-fold. First, large firms might be tempted to overcharge their customers while acting on both sides of the transaction. Second, exchange specialists might be competitively disadvantaged because they would have no access to member firms' order flow.

The need for a so-called "anti-internalization" or "order exposure" rule was felt by some in the industry to be a critical precondition to carrying out the linkage experiment. The Commission, however, declined to construct a rule, because it believed the linkage would provide substantially increased market efficiency and opportunities to assure best execution without broadening the risks attributed to internalization. The Commission invited the market participants themselves, if they were convinced such a rule was necessary, to prepare it, for review by the Commission. In this way, the Commission has not only deferred to private sector initiative, but should gain the maximum benefit of private sector expertise in a highly technical area.

It is interesting to note that in this case some in the private sector were urging protective action by the regulators against only the possibility of abuse, and we were declining to regulate without a solid showing of need.

Multiple Trading. A similar issue recently arose when the Commission considered whether it should restrict trading in the options on certain non-equity securities solely to the securities exchange which first proposed this new product. In order to protect their competitive positions, some of the securities exchanges were eager to obtain exclusive rights to offer their products. In addition, it was argued that fragmentation would result from multiple trading of these products to the detriment of the public. Thus, Commission assignment of a single market for each new product was required.

Once again, the Commission declined to impose a regulatory solution, in the absence of convincing evidence that fragmentation or other disadvantages would outweigh the blessings of competition, actual or potential. This decision, of course, should not be read as a signal from the Commission one way or the other as to options on equity securities, where different considerations may apply.

Again, somewhat ironically, we declined an invitation from some in the private sector to impose more, rather than less, regulation.

So much for the examples. They should help to show the path we are trying to follow. We are open to suggestions. Indeed, with the inevitable blind spots a regulator can develop, we need all the help from the private sector we can get. The regulatory problems I alluded to earlier are real, and the solutions difficult.

James Madison, who knew of these things, said:

> "In forming a government which is to be administered by men over men, the great difficulty lies in that you must first enable government to control the governed, and in the next place oblige it to control itself."

Two hundred years later, the country is still wrestling with Madison's two tasks. They have not grown appreciably easier, even with the benefit of two centuries of experience. I suspect they never will.