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The SEC and the Public Interest

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THE SEC AND THE PUBLIC INTEREST. By *Susan M. Phillips* and *J. Richard Zecher*. Cambridge, Mass.: MIT Press. 1981. Pp. ix, 120. $22.50.

Although the federal government has heavily regulated the securities industry for nearly fifty years, commentators are still unable to agree whether its regulatory program has actually aided investors. The Securities and Exchange Commission's (SEC) successful deregulation of the New York Stock Exchange's (NYSE) fixed commission rates stands in marked contrast to its failure to provide any clear goals for the development of a national securities market.[1] And the SEC's corporate disclosure system continues to expand despite studies indicating that the costly disclosure requirements produce little or no benefits. In *The SEC and the Public Interest*, Susan Phillips and J. Richard Zecher use economic theories of regulation to explain why the SEC's efforts have produced these mixed results. They conclude that the SEC is best viewed as a broker balancing out the strongly competing groups in the securities industry. The book's extensive reliance on economic theory and empirical data will deter many readers, but those interested in regulatory theory or the intricacies of the regulatory process will gain some insight into the forces influencing the SEC and other regulatory agencies.

After reviewing the historical development of the SEC and the premises on which it was founded, Phillips and Zecher describe two economic theories of regulation that underlie most of their analysis. The "market failure" theory suggests that failures within or devia-

5. *Corporations and Information* is also reviewed by Howell, Book Review, 67 A.B.A.J. 618 (1981); Wilson, Book Review, 105 LIB. J. 1626 (1980).

1. Securities Act Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified at 15 U.S.C. § 78b (1976)).

tions from a purely competitive marketplace justify regulatory programs that approximate free market solutions (p. 24). Regulatory agencies, market failure theorists argue, should define the market conditions that will serve the public interest, establish regulatory criteria, and conduct ongoing cost-benefit assessments of their programs. Many of these programs, however, have not worked as intended, and economists have turned to a second regulatory theory — "public choice" — to explain why well-intentioned and well-designed regulatory efforts might fail.

The public choice theory posits that every regulatory action reallocates resources: some sectors of the economy gain while others bear a "regulatory tax." The regulatory agency, this theory holds, seeks to maximize support for (or, alternatively, to minimize opposition to) its programs. Because the cost of effectively organizing a diffuse interest group is often high relative to the amount of the regulatory tax, small groups with well-defined economic interests at stake often succeed in imposing such taxes on larger groups. Regulatory managers, therefore, have little incentive to discuss specific, measurable goals or to subject their actions to cost-benefit analysis (pp. 24-25). The public choice theory also predicts that agencies will impede the formation of opposition groups by obfuscating the regulatory process.

These two theories, Phillips and Zecher believe, can provide a framework for analyzing federal regulation of the securities market. They consider in depth the corporate disclosure system, the deregulation of fixed commission rates, and the development of a national market system for securities. Their analysis indicates that the facially competing theories actually complement each other: Market failure explains why regulations are enacted, and public choice explains why they fail to achieve their stated goals. Ultimately, the authors conclude that the SEC's involvement in each of these three areas is best explained by the public choice theory.

The first regulatory program examined — corporate disclosure — was based on the market failure theory. Congress enacted the Securities Act of 1933[2] in response to a perceived market failure in the stock market crash of 1929. It believed that disclosure would allow investors to make informed decisions and protect them from price manipulators and corporate mismanagement. Phillips and Zecher, however, question whether the abuses were as widespread or harmful as Congress and the public believed (pp. 28, 36). Using efficient pricing of securities as the measure of the "public interest," for example, the authors argue that insider trading moves prices to a new equilibrium level that could offset price manipulation (p. 36). The

2. 15 U.S.C. § 77a (1976 & Supp. IV 1980).

unfairness to investors without inside information is basically ignored.

The authors then attempt to document and explain the failure of disclosure requirements. Their review of pricing efficiency reveals that disclosure has not significantly improved the pricing of securities. They also estimate that corporations spend about a billion dollars annually to comply with the disclosure requirements. Because they conclude that disclosure fails any rational cost-benefit test, they turn to the public choice theory to explain why the requirements encounter little organized resistance. Their explanation is straightforward: Securities lawyers and accountants who prepare disclosure documents and analysts who receive them free are relatively small, well-organized groups that benefit from the current system. But the corporations and investors that pay for the system are either ignorant of the burden or unbothered by it.

Phillips and Zecher again rely on the public choice theory to analyze the SEC's role in the successful deregulation of the NYSE's fixed commission rates. They use the Stigler-Peltzman model of public regulation[3] to develop hypotheses regarding wealth transfers between competing groups and the relative responsiveness of the SEC in allowing rate changes caused by increases in production costs or shifts in demand. The hypotheses are tested using empirical data on brokerage costs for transactions of various sizes and the shifts in market composition caused by the increased importance of institutional investors. Since many of the hypotheses tested have little practical relevance to the SEC, it is unclear whether the authors seek primarily to explain the SEC's actions or to test the validity of the underlying economic theory of regulation.

Fixed commission rates, Phillips and Zecher claim, benefited small groups of brokers and exacted a small regulatory tax from all investors. As institutional investors, who were paying an increasingly large regulatory tax, grew in importance, and as the Justice Department and Congress pressured the SEC to deregulate commission rates, the SEC slowly abandoned its support for the NYSE brokers, first by allowing some lower commission rates for large transactions and eventually by full deregulation. The success of the deregulatory effort despite strong opposition by the NYSE undermines the popular notion that regulatory agencies are captives of the industries they regulate. Rather, under the public choice theory, the regulator as broker will permit shifts in programs when competing groups can effectively oppose the current beneficiaries of regulation.

Although the authors offer a public choice explanation for the SEC's success in deregulation, the market failure theory could also

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3. *See* Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 213-22 (1976).

explain the Commission's actions. Fixed commission rates existed long before the establishment of the SEC. Congress, by not ordering the system dismantled, appeared to approve its continuance, allowing the SEC to regulate it. But the increased importance of institutional investors may have *caused* a market failure because reduced costs were not reflected in commission rates. Congress may have perceived this failure and directed the SEC to correct it. The Commission succeeded in this goal, despite bitter opposition by the NYSE.

In addition to pressuring the SEC to deregulate commissions, Congress directed it to facilitate the development of a national market system. The SEC, however, has not taken any firm steps toward that goal. Phillips and Zecher examine evidence tending to show that the NYSE is the lowest-cost producer in the security exchange industry and thus may be a natural monopoly.[4] The authors believe that the SEC's lack of success in the market structure area results from its attempts to promote competition among the regional exchanges. By issuing regulations designed to help the regional stock exchanges compete with the NYSE, the SEC is impeding a natural process that would otherwise evolve into a national market system. In sum, the view presented is that the "public interest" would be served by allowing the NYSE to become a monopoly by free market forces, thus passively "fulfilling" Congress's mandate for a national market system.

The SEC and the Public Interest is part of the increasingly vocal attack on regulatory agencies by economists who define "public interest" as free market solutions and who have decided that the free market is preferable to regulation.

Although Phillips and Zecher's research is not definitive, their work should challenge economists and policy-makers to reexamine the purposes and effects of the Commission's regulations. Readers should be warned, however, that few of the authors' conclusions are novel, and that their style of presentation makes the book relatively inaccessible to those untrained in microeconomic theory.

4. The discussion of whether the NYSE is a natural monopoly relies heavily on Robert W. Doede, The Monopoly Power of the New York Stock Exchange (1967) (Ph.D. dissertation, Department of Economics, University of Chicago). The authors update Doede's findings using statistics on exchange seat prices for the period following deregulation.