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# The Role of Government in the Securities Market

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*The author discusses the need for and the desirability of governmental regulation of the securities market. This assessment, which is made from an economic perspective, leads to the conclusion that the SEC is ineffective in protecting investors and that the regulatory role of the government should be diminished.*



## I. INTRODUCTION

When a specialist in one area overcomes the sense of timidity that usually deters his venturing into another discipline, the greeting he receives is often less than enthusiastic. Practitioners in the field tend to view him as something of an intellectual imperialist and to dismiss his observations as overly simplistic. Their facial reactions usually tell the story, ranging from a grimace at the cheekiness of the intruder to a nod to one or another of their colleagues as if to say, "Well, what he proposes is all well and good but the issues are just much more complex."

Fortunately, the link between economics and law is a good deal stronger than those that bind most other disciplines. The reason, of course, is that much of our legislation is rationalized along economic lines. A fair amount of it deals with what are narrowly conceived to be economic issues—the securities market, as every economist who has ever been buttonholed at a cocktail party for a stock tip can attest, being perhaps the prime example—and almost all of it has an economic impact, however indirect.

Before examining the appropriateness of legislation dealing specifically with the securities market, I will briefly review the ways in which economists have tended to view the regulatory process in general. After outlining the conditions under which governmental regulation can confer a net economic benefit on society, I will consider some of the empirical evidence that has been amassed on the extent to which regulation actually has this effect.

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The result of that exercise necessarily leads me to ask the question about securities regulation that Professor Loss, at the outset of his remarks, explicitly sought to avoid: whether we need a federal securities code to begin with.[1]

The answer, as I see it, is no. Historical analysis of the economic situation at the time the SEC was set up, contrary to the folklore surrounding the period, does not reveal any reason for singling out the securities market. And the weight of the evidence from detailed empirical studies of securities market regulation shows little or no positive economic effects.[2] Given the costs of maintaining the regulatory apparatus and of compliance with regulatory legislation and SEC directives, the net impact of such regulation is, therefore, likely to be negative. A new securities code that will leave many features of the current system of regulation intact seems to me hardly likely to shift the balance in the opposite direction.

Government can, however, play a positive role in the securities market, but to do so, it will have to follow a far different path from the one it is on now. I discuss this at the end of the paper.

## II. Regulation: Some First Principles

Economists' standard rationale for governmental regulation and other forms of governmental intervention is the existence of market imperfections in particular industries.[3] According to the theory, these flaws result in too little or too much of a particular good being consumed or produced, as the case may be. In short, the industry is economically inefficient. Underproduction would occur, for instance, if a firm had a monopoly position. To maximize its own profit position, it would be led to restrict its output, thus increasing the price of its product to a point where it no longer equaled the costs of production, which include a competitive return to the owners of the firm on their investment. Government regulation that increased competition would lead to an increased output and a lower price. Economic efficiency would, therefore, be enhanced, since the larger output would result in some shift of capital and labor to the industry where, had the market worked well, they would have been employed to begin with. At the same time, consumers would be better off since the lower price would enable them to increase their purchases of that industry's product rather than hav-

1. Loss, *Keynote Address: The Federal Securities Code*, 33 U. Miami L. Rev. 1431 (1979).
2. *See* text accompanying notes 3 & 4 *infra*.
3. *See, e.g.*, R. Posner, Economic Analysis of Law, 271-86 (2d ed. 1977).

ing to settle for some less-valued substitutes.[4]

Overproduction and overconsumption might occur if one of the resources an industry used were priced below its true value. For example, consider a chemical firm that freely discharged effluents into a nearby lake. The firm would be treating one resource, water, as if it had no value at all. In actuality, however, as anyone who has compared prices of waterfront houses with those further inland can attest, clean water is usually far from free. If government regulatory action forced the firm to treat the waterway at its true cost by compensating other users of the lake, then there would be a salutary economic effect. The resulting higher product price would eliminate the overconsumption, and hence, the overproduction of the chemical. And the pollution of the lake—the wasting of a scarce resource, clean water—would be reduced.

A big "if" in all of this, however, is how far the government goes in its regulatory actions. If government regulators were to totally elimate water pollution, even in cases where the lake, although polluted, had alternative uses and, therefore, a positive value, then economic efficiency might well decrease rather than increase. A similar result would obtain if they were to push the price in a monopolistic industry below the true cost of production. In both instances, the cure would be worse than the disease.

Whether or not regulation is ultimately beneficial depends in part upon the information available to the regulators. For their actions to result in an economic benefit greater than that inherent in the original situation, they would have to have a good deal of knowledge about the industry being regulated. In our rationalistic age, in which mathematical models of the economy and the computers used to implement them have taken on the role of idols, one might presume that such knowledge would be easily acquired. But, as Noble Laureaute F.A. Hayek has pointed out in a now classic discussion of the subject,[5] the opposite presumption is likely to be closer to the truth. In an economy as complex and rapidly evolving as ours, producers continually have to adapt to new information. To do so requires a high degree of specialized knowledge. That knowledge is unlikely to be available to the regulator. The potential for error, and, hence, of worsening an already imperfect situation is great.

A more serious objection to the standard story about government regulation, however, is that it begs the question of what the

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4. *Id.* at 3-14.

5. Hayek, *The Use of Knowledge in Society*, 35 AM. ECON. REV. 519 (1945).

regulations are designed to do. It presumes that the prime motivating force behind regulatory legislation is the redress of economic wrongs, that what matters to legislators is economic efficiency.

While public interest theories of legislation such as this may help sell grammar school civics texts, and for that matter introductory college economics textbooks, they strike the more perspicacious observer as somewhat naive. The problem with the argument is that each legislator is presumed to have an overriding concern with things economic except where they impinge directly upon his own well-being—a man of economics, but not an economic man. Indeed, the most ascetic professor of economics in the nation's most prestigious research institution hardly minimizes profits.

And that's the rub. There are powerful forces that push legislators along paths that are quite divergent from those leading to the public good. Many economists would now argue, as George Stigler has done,[6] that studies of government regulation lead to the conclusion that the motivating force behind it is not the public interest but some well-organized group with political clout—be it a trade or professional association, a labor union or whatever—that will benefit from the regulations. The reason, in Stigler's view, is that the benefits of regulation accrue to relatively few while the negative effects are, in general, spread out over the rest of society. Thus, however great the losses may be in the aggregate, they are sufficiently small for any individual not part of the group benefited that lobbying against regulation does not pay. The costs to him from doing so exceed the potential gains.

How closely the details of Stigler's model fit the facts has been debated.[7] Studies of regulation such as those reviewed by William A. Jordan and Richard A. Posner in their detailed surveys of the literature show that its general thrust is entirely correct.[8] In no

6. Stigler, *A General Theory of Regulation*, 2 BELL J. ECON. & MNGMT. SCI. 3 (1971).

7. *E.g.*, Peltzman, *Toward a More General Theory of Regulation*, 19 J. LAW & ECON. 211 (1976). Peltzman contends that the benefits and liabilities of regulations are a function of the economic climate in which they were passed. He extends Stigler's model to try to explain what he regards as the more general outcome in a regulated market. "Regulations will tend to be more heavily weighted toward 'producer protection' in depressions and toward 'consumer protection' in expansion." *Id.* at 227.

8. Jordan, *Producer Protection, Prior Market Structure and the Effects of Government Regulation*, 15 J. LAW & ECON. 151 (1973); Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MNGMT. SCI. 335 (1974).

A conclusion related to that drawn in Stigler's model was reached in a study of the effects of deregulation in a particular market. The authors determined that deregulation resulted from changes in the economic interests of the groups affected by fixed commission rates instance that they cite does the traditional explanation of promotion of the public interest, in the sense of increasing economic efficiency, appear to hold. Stigler's alternative explanation, or something close to it, proves far superior.

## III. Regulation and Securities Markets

Given this general experience with regulation, one necessarily has to be somewhat dubious about whether the SEC's regulation of the securities markets serves the public interest. The Commission claims, of course, that it does.

The Commission rationalizes its role with the observation that "securities are by their very nature much different from almost any other type of 'merchandise' for which there are established public markets."[9] The reason for the difference, the agency says, is that individuals have greater difficulty evaluating the true worth of securities than that of any other good.[10] As the SEC sees itself, its mandate is to overcome these difficulties, to ensure that firms provide adequate information to buyers of securities and to eliminate fraudulent practices in their sale.[11]

The economic turmoil of the Depression era, the period in which the first securities acts were passed, seemed to lend credence to the idea that such governmental actions were needed. So, before going on to consider the internal logic of the SEC's argument, I would like to review briefly what happened then.

In 1933, the country had just gone through the stock market crash of 1929 and was still in the throes of its worst depression. The crash, moreover, was widely viewed as its cause. Added to that were the equally widespread beliefs that the securities market was rife with fraudulent practices and that business in general had failed the nation. It is not surprising, therefore, that securities regulation came into being when it did. What is surprising, given the new knowledge we have gained since 1933 about the causes of the Depression, is that the historical rationale for securities regulation has remained virtually unquestioned.

Popularized accounts of the era notwithstanding, it is now quite

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established by the regulations. Roberts, Phillips & Zecher, *Deregulation of Fixed Commission Rates in the Securities Industry,* in THE DEREGULATION OF THE BANKING & SECURITIES INDUSTRIES 151, 161 (L. Goldberg & L. White eds. 1979).

9. SECURITIES & EXCHANGE COMMISSION, THE WORK OF THE SECURITIES & EXCHANGE COMMISSION, forward (Wash. D.C. 1978).

10. *Id.*

11. *Id.* at 1.

clear that the stock market crash had little to do with the economic upheaval that subsequently occurred. The major reason the Depression became so severe, as Milton Friedman and Anna Schwartz in their study of U.S. monetary history have demonstrated,[12] was not the severity of the stock market crash but the ineptitude of Federal Reserve monetary policy at the time. In the face of a protracted series of banking panics, the Federal Reserve stood pat. It kept its own monetary liabilities—currency and bank reserves—virtually constant throughout the period. The result was that banks failed en masse and the amount of money in circulation—currency and commercial bank deposits—fell by an historically unprecedented 33%. The effect on output and unemployment was catastrophic.

Relative to that shock to the economy, the stock market crash in 1929 was at most a minor exacerbating factor. It may have helped to initiate the onset of the Depression but could hardly account for either its severity or extended duration. The decreases in stock prices that took place in the 1930's, as opposed to those in late 1929, were more the result than a cause of what happened elsewhere in the economy. Rather than being a reflection of some previous overvaluation of equities by the market, they appear to have been a response to the rapidly deteriorating business environment.[13] It is, therefore, doubtful that any amount of information of the type now required by the SEC could have avoided that part of the price fall.

Now, what about the allegation that the market for securities is different from all other markets? Suppose for a moment we take a look at other investment goods. Housing and other consumer dura-

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12. M. FRIEDMAN & A. SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867-1960, at 299-419 (1963); Friedman & Schwartz, *Money and Business Cycles*, 45 REV. ECON. & STATS. 32, 52 (Supp. 1963).

For a critical analysis of the view that the Great Depression was the result of a series of special events, one of which was the stock market crash, see Gandolfi & Lothian, *Did Monetary Forces Cause the Great Depression: A Review Essay*, 9 J. MONEY, CREDIT & BANKING 679 (1977).

13. Movements in stock prices over the period are revealing in this regard. The crash itself obviously had a sizeable impact—the monthly Standard and Poor's composite index (1941-43=100) fell dramatically from its post World War I peak of 31.30 in September 1929 to 20.58 in November. But that was it. In the next six months, close to half of that movement was reversed and even as late as September of 1930, the index had still not fallen below its November 1929 level. By far the greatest drop occurred thereafter in the period when the Depression could have been expected to worsen for other, particularly monetary, reasons. The index fell with minor interruptions through 1931 and 1932 until it finally bottomed out at 4.77 in June of the next year. *Cf.* M. FRIEDMAN & A. SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867-1960, at 304 (1963) (charting Standard & Poor's common stock price index, 1929-33). If the crash had been largely responsible for the Depression, then it is far from obvious why stock prices followed the course they did.

bles like cars, calculators, stereo equipment, appliances and even education are prime examples. The nature of these goods is such that evaluating their quality usually requires highly specific knowledge, something that few people possess prior to seriously entertaining the idea of purchase. But even though none of these markets is heavily regulated in the sense that there is no mandatory disclosure of information pertaining to product quality, anyone who so desires can usually find out what he wants to know. The reason is that the market provides information in one way or another.

Consider education, for instance. Universities as a whole and particular departments within them establish reputations and publish literature that provide indications of the quality of their faculties. In addition, various independent sources publish rating reports to which one can refer. Similarly, in the area of housing, there are consulting engineers and, often times, real estate agents, who for a small fraction of the purchase price will evaluate the condition of a house. In like manner, buyers of most other consumer durables can use the reputations of the manufacturers and retailers as general indicators of product quality and of the availability of repair services. Consumers willing to search for it can obtain additional information through magazine and newspaper columns, independent product-testing agencies and product prices. In these areas in which consumers make important, investment-type expenditures, the values of the products are difficult to ascertain. Nevertheless, buyers seem to be able to acquire reasonably good information about quality, despite the absence of governmental regulation.

If the securities market is indeed different from those for other goods, then this variance must arise from something other than the difficulty of ascertaining the values of securities, which is the SEC's claimed distinction.[14] I maintain that the differences run mostly in the opposite direction, that information can be more easily come by in the securities market than in most other markets. The principal reason is that the securities market is better organized and more highly integrated than most other markets. So, even if participants in the securities market had exactly the same characteristics as those in other markets, one would expect the securities market to be more efficient. Securities prices incorporate all relevant information more rapidly and, hence, at any point in time, they should be better indicators of product worth than prices in most other markets.[15]

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14. *See* notes 9 & 10 and accompanying text, *supra*.

15. There is now an extensive literature on this subject. For a summary article, see

Adding to this greater efficiency of securities markets, I suspect, is the sophistication of market participants.[16] This should be greater in securities markets than elsewhere, since the potential returns from accumulating such knowledge are likely to be higher in securities markets. Individuals who purchase or sell securities often do so on a fairly regular basis. By contrast, individuals dealing in other markets, like those for houses or automobiles, generally engage in transactions much more infrequently. Therefore, they would have less incentive to build up knowledge about those markets than would the more regular participants in securities markets.

One question a proponent of regulation would ask, however, is whether accurate information would be forthcoming if regulations did not exist. In the abstract, the answer seems clear. As Professor Benston pointed out, an incentive for firms to disclose information valued by investors would exist even in the absence of the SEC.[17] If investors valued a particular type of information and a firm withheld it, then the firm's stock would sell at a discount.

The SEC views disclosure of information by firms offering to sell securities as more than a means of enabling investors to evaluate the true value of the securities. The regulations are intended also to prevent fraudulent practices in the sale of securities.[18] Just as mandatory disclosure is not needed to inform buyers of the value of stocks, however, it is unnecessary to effect this second of the SEC's stated goals. The disclosure required by the securities regulations is not an investor's sole safeguard against fraud. The function of independent auditors is to report fully and accurately about a firm's financial status. This role can be carried out as easily in an unregulated as in a regulated environment.

There is little evidence that the type of information which firms are required by the SEC to disclose is very valuable to begin with. In addition to the pioneering work of George Stigler in this area,[19] there are a number of papers by Professor Benston[20] and others[21]

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Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work,* 25 J. FINANCE 383 (1970).

16. For an analysis of the relationship between the knowledge of market participants and their responsiveness to new developments in the market in the context of farmers' adoption of new technology, see Huffman, *Allocative Efficiency: The Role of Human Capital,* 91 Q.J. ECON. 59 (1977); Huffman, *Decision Making: The Role of Education,* AM. J. AGRICULT. ECON. 85 (1974).

17. Benston, *Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code,* 33 U. MIAMI L. REV. 1471 (1979).

18. *See* text accompanying note 11 *supra.*

19. *E.g.*, Stigler, *Public Regulation of the Securities Markets,* 37 J. BUSINESS 117 (1964).

20. *E.g.*, Benston, *An Appraisal of the Costs and Benefits of Government-Required*

that lead to the conclusion that this information is not of value to the investor.[22]

The only area in which the SEC appears to have had a measurable effect is the brokerage industry. The introduction of SEC regulation appears to have adversely affected profits of brokerage firms while the more recently mandated change in brokerage fees appears to have made those fees more competitive.[23]

## IV. Summary and Conclusions

Close to a decade ago, the American Enterprise Institute sponsored a debate between George Stigler and former chairman of the SEC Manuel Cohen on whether regulatory agencies can protect the consumer.[24] Stigler's conclusion was that the SEC had been of no benefit whatsoever to investors. He issued a call for the SEC to produce bona fide scholarly evidence on the subject, saying that "the presumption has got to be on the regulatory body to show what it's doing, not upon those who are outside."[25]

Since then, the only studies that I know of have come from outside and, in the main, they have hardly served to shore up the SEC's position.[26] Given the dearth of favorable evidence and given what I regard as extremely tenuous historical and logical arguments in behalf of the SEC, out and out repeal of the securities codes might be the route to take.

If the idea were truly to aid investors, then eliminating regulation seems to be the preferable alternative. The simple fact is that compliance with SEC disclosure rules has some costs, perhaps fairly considerable ones. The proliferation of regulation in recent years doubtless is one reason for the poor performance of the equity markets.

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*Disclosure: SEC and FTC Requirements,* 41 L. CONTEMP. PROB. 30 (1977); Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934,* 63 AM. ECON. REV. 132 (1973).

21. *E.g.*, Kripke, *The Myth of the Informed Layman,* 28 BUS. LAW 631 (1973).

22. There are various recently published results that are consistent with the finding. *E.g.*, Horowitz & Kolodny, *Line of Business Reporting and Security Prices: An Analysis of an SEC Disclosure Rule,* 8 BELL J. ECON. 234 (1977) (investigating newly proposed line-of business reporting); Jaffe, *The Effect of Regulation Changes on Insider Trading,* 5 BELL J. ECON. 93 (1974) (investigating effect of introduction of rules prohibiting insider trading).

23. *See* Ofer & Melnick, *Price Deregulation in the Brokerage Industry: An Empirical Analysis,* 9 BELL J. ECON. 633 (1978); Schwert, *Public Regulation of National Securities Exchanges: A Test of the Capture Hypothesis,* 8 BELL J. ECON. 128 (1977).

24. G. STIGLER & M. COHEN, CAN REGULATORY AGENCIES PROTECT THE CONSUMER? (1971).

25. *Id.* at 73.

26. *E.g.*, Kripke, *A Search for a Meaningful Securities Disclosure Policy,* 31 BUS. LAW 293 (1975).

What I suspect has played an even greater role is the type of macroeconomic policies that the government has followed. The high and variable rates of inflation that the United States and most other industrial countries have experienced since the mid 1960's have been the direct outcome. The uncertainty that has resulted has increased the costs of doing business and, I would argue, has had an even greater negative impact on securities prices than all of the regulations combined.[27]

A return to stable macroeconomic policies and a diminution of the government's role in the microeconomic sphere—curbing the powers of the SEC, FTC and virtually every other acronymic agency one would care to mention—to my mind would go farther in protecting the individual investor than anything else.

27. *See generally* P. CAGAN & R. LIPSEY, THE FINANCIAL EFFECTS OF INFLATION (1978); Friedman, *Nobel Lecture: Inflation and Unemployment*, 85 J. POL. ECON. 451 (1977).