

THE SEC AS A LAWMAKER: CHOICES ABOUT INVESTOR PROTECTION IN THE FACE OF UNCERTAINTY

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I. PREFACE

A problem that has dominated much of recent corporate legal scholarship is one of political economy: what drives (and constrains) the production of corporate law? As used here, “corporate law” refers to the body of regulation dealing with the allocation of power, rights, and responsibilities relating to management and control of the corporation—a rough description that includes many of the disclosure-related demands of federal securities regulation. My paper will look at the portion of corporate-securities law that is produced by the Securities and Exchange Commission (SEC). Put simply, what drives and constrains the SEC as a federal corporate lawmaker?¹

My impression is that most scholars’ beliefs about how and why the SEC makes law are simply derived from their “priors” about the virtues or vices of regulatory competition. Legal scholarship has gone through phases on that issue. Much of the last century’s early writing was disdainful of giving state corporate law primacy given the competition for charters, fearing that this produced a “race to the bottom.” This view naturally put the SEC in a favorable light. Then suddenly in the late 1970s there was an embrace of the virtues of competitive federalism in corporate law. So the dominant scholarly narrative in which federal regulation largely played a heroic role was replaced by one viewing it with skepticism if not outright hostility.² By the 1990s much of the discourse

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1. To be sure, the SEC does much more than corporate lawmaking. Regulation of the stock markets and the securities industry is the larger part of its statutory assignment. Much of the analysis in this paper extends to that role as well. And politically, there are interesting connections; for instance, the influence of the securities industry and its interests may affect the SEC’s actions vis-à-vis corporate governance. *See infra* note 26.

2. State primacy came to be seen as good, and more importantly, better than federal regulation because states were in competition with each other for chartering business and could not afford to pander to managers because investors would exact a penalty in the capital marketplace for suboptimal shareholder protection. By contrast, Congress and the SEC were far less constrained by regulatory

was about taking power away from the SEC and giving it to the states or private entities such as the stock exchanges, or at least permitting easy issuer “opt out” from the federal regime.³ More recently, there has been another shift as concerns about Delaware’s monopoly powers have led to renewed claims that the federal government is the only real counterweight to keep the system in balance.⁴ Some scholars, dissatisfied with the current state of shareholder protection, again look eagerly to federal intervention for help on matters such as excesses in executive compensation and shareholder access to the election ballot.⁵ But this turn is only partial. Corporate federalism still has many enthusiastic adherents who see the renewed vigor in Washington as political quackery or worse.⁶

My point is that where one stands in this debate on regulatory competition seems to determine how one views lawmaking by the SEC. Either the SEC makes law well because the states tend to generate problematic law, or the SEC makes law poorly because competitive federalism is good. What is missing, however, is careful and sustained attention to the SEC as an institution. To be sure, we have an increasing amount of research using event studies and other techniques to assess the quality of particular SEC regulations,⁷ with predictably varying results. Some of its judgments are better than others from the standpoint of investor welfare (which is true of the states’ choices as well). But we understand relatively little about how, when, or why.⁸

competition, making federal law suspect. See ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION* 112–47 (2002).

3. Although there were many judicial decisions that reflected the preference for competitive federalism and hence a narrowing of the scope of the federal securities laws, the shift was incomplete, and today the case law is quite open-ended in terms of the ability to treat breaches of fiduciary duty and other “state” matters as federal issues. See Donald C. Langevoort, *Seeking Sunlight in Santa Fe’s Shadow: The SEC’s Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449 (2001); Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 46–49, 59–60 (1993); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 881–87 (2003).

4. See Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588 (2003).

5. See, e.g., Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

6. See Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521 (2005).

7. See Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 820–28 (2006).

8. My earlier thinking on this can be found in Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formulation*, 47 WASH. & LEE L. REV. 527 (1990); for a response, see Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994). Some of Macey’s ideas are taken up and reconsidered in A.C. Pritchard, *The SEC at 70: Time for Retirement?*, 80 NOTRE DAME L. REV. 1073 (2005).

This paper is an effort to stimulate further inquiry into the administrative behavior of the SEC, on which there has occasionally been good writing in the law, economics, and political science literature, but not nearly enough. Of course, one should view the SEC as just one agency among many in the federal regulatory apparatus, and much learning can come by drawing from more generalized accounts of administrative behavior.⁹ I have no comparative advantage to offer here, and so will attend to the particular institutional features of the SEC that might be of interest, and to the academic literature that is specifically about the SEC.¹⁰ That said, empirical work comparing the SEC's behavior to other agencies along measurable dimensions is much needed and in the discussion that follows, I suggest some possible research projects.

I also want to ground my speculations in the law by considering a recent lawmaking episode.¹¹ The mutual funds scandals of 2003 (uncovered not by the SEC but by Eliot Spitzer, New York's Attorney General) led to a flurry of rulemaking at the SEC. One set of rules, the product of a rare 3–2 split vote on the Commission, effectively required mutual funds to increase the percentage of independent directors on their boards to 75 percent, and to have an independent board chair.¹² The U.S. Chamber of Commerce brought suit challenging the validity of the rule, and the D.C. Circuit struck it down on grounds that the Commission had done an inadequate cost-benefit analysis.¹³ The Commission responded by redoing its analysis very quickly so the rule could be reconsidered before Chairman Donaldson left office. On nearly the last day of his term, the Commission readopted the rule by the same 3–2 vote.¹⁴ The Chamber promptly renewed its legal challenge, and the court again barred

9. The literature here is, of course, voluminous. *See, e.g.*, Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1 (1998).

10. Book-length treatments include both critical and sympathetic portraits. For the former, see SUSAN M. PHILLIPS & J. RICHARD ZECHER, *THE SEC AND THE PUBLIC INTEREST* (1981); for the latter, see BILLY RAY HALL, JR., *A LEGAL SOLUTION TO GOVERNMENT GRIDLOCK: THE ENFORCEMENT STRATEGY OF THE SECURITIES AND EXCHANGE COMMISSION* (1998); ANNE M. KHADEMIAN, *THE SEC AND CAPITAL MARKET REGULATION* (1992). An outstanding history of the SEC, which paints quite a sympathetic portrait, is JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* (3d ed. 2003).

11. *See infra* notes 74–75.

12. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378 (Aug. 2, 2004), available at www.sec.gov/rules/final/ic-26520.htm.

13. Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

14. Investment Company Governance, Commission Response to Remand by Court of Appeals, Investment Company Act Release No. 26,985, 70 Fed. Reg. 39,390 (July 7, 2005), available at www.sec.gov/rules/final/ic-26985.pdf.

implementation of the new regulations on procedural grounds.¹⁵ The SEC says it will revisit the issue, albeit under new leadership.¹⁶

This is not meant to be a mutual fund governance paper, and so my interest is less in this particular result than the underlying process. Was the issue the Commission had before it one that could be resolved by comparing costs and benefits, or was it more speculative? If the latter, how might the speculation have played out internally? The administrative law question at issue in the *Chamber of Commerce* litigation was how demanding courts should be in reviewing agency assessments of costs and benefits. Without trying to answer that question as a general matter—and the fact that the Chamber brought this case even though it has very little connection to the mutual fund industry is a strong hint that its political objective was to prompt a shift toward more judicial activism generally in scrutinizing SEC lawmaking—it seems intuitively right that understanding agency judgment and decision making better is a helpful first step. Hence I will try to connect this particular choice to the literature on how the SEC exercises “speculative” discretion when costs and benefits are ambiguous.

II. EXTERNAL CONSTRAINTS AND INTERNAL DISCRETION

The literature on competitive federalism in the making of corporate-securities law has a curious inconsistency. The SEC is frequently criticized because it is inward looking and unconstrained by market forces. Hence the image of the blundering monopolist regulator. Implicitly, however, that assumes a great deal of bureaucratic “slack.” But such “slack” is not self-evident, particularly from the standpoint of the public choice and capture theories¹⁷ that legal economists (including many other critics of the SEC) are otherwise inclined to invoke.¹⁸ Corporate managers, the securities industry, and institutional investors have substantial influence in Congress. If Congress can effectively control its administrative agencies, the SEC should be quite responsive to the resulting political agenda.

15. *Chamber of Commerce of the U.S. v. SEC*, 443 F.3d 890 (D.C. Cir. 2006). This opinion was concerned almost entirely with the process following the initial remand, and thus is less interesting on the lawmaking question.

16. *Investment Company Governance*, Investment Company Act Release No. 27,395, 71 Fed. Reg. 35,366 (June 19, 2006).

17. See, e.g., Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167 (1990).

18. E.g., David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311 (1987). For a critical perspective, see David A. Skeel, Jr., *Public Choice and the Future of Public Choice Influenced Legal Scholarship*, 50 VAND. L. REV. 647 (1997) (book review).

Obviously, either view of the SEC could justify a critical stance about its decision making. But critics and their audiences have to choose their theory with some care because both the diagnosis and the cure one might recommend from a “slack” perspective would differ considerably from one based on public choice.

An interesting political puzzle that Mark Roe has addressed in his recent writings on the production of corporate law helps expose this tension. Why would a political coalition of managers and investors prefer Delaware on matters of corporate governance when they also have such clout at the federal level, and presumably could just as easily mold uniform federal corporate regulation (including the SEC’s) to reflect whatever political compromise they reach?¹⁹ The answer he gives is that this coalition can *usually* dictate such a result, but not always. This brings us to an important piece of the political economy story. It is far from obvious, as a vocal minority of corporate law scholars have long rightly argued, that corporate law is necessarily *just* about balancing the interests of managers and investors.²⁰ Other stakeholders (e.g., labor, customers, or the public at large) can plausibly claim an interest in influencing the processes of corporate governance in public corporations away from profitability or share price maximization and toward some other goal, such as public accountability or social responsibility. Politics being what it is, those other stakeholder interests will not dominate except in times of extraordinary scandal or crisis. But scandals and crises are predictable enough.²¹ As a protective device, Roe argues, managers and investors influence Congress to delegate its governance authority to the states within the constraint of the internal affairs doctrine. This guarantees that Delaware—where labor and other stakeholders have no local political

19. Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491 (2005). The underlying question here is why Congress, which certainly has the power to regulate corporations under the Commerce Clause, would be willing to cede such authority to a state like Delaware. This question has interested many other scholars as well, producing an important body of corporate law research dealing with the interaction between Delaware and the federal government. See, e.g., Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573 (2005); William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism* (ECGI-Law Working Paper No. 23/2004; Georgetown Law and Econ. Research Paper No. 606481, Nov. 2004), available at www.ssrn.com/abstract=606481. The assumption in nearly all this work is that the SEC willingly carries out the federal political agenda, however that is defined.

20. With respect to securities regulation, see Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197 (1999).

21. See Stuart Banner, *What Causes New Securities Regulation?: 300 Years of Evidence*, 75 WASH. U. L.Q. 849 (1997).

clout—determines the bulk of corporate law rather than bigger states like New York or California, where stakeholder voices can be stronger.²²

Where, then, is the SEC and federal securities regulation in this story? Roe's account places the SEC somewhere between Congress and Delaware, less subject to control by the manager-investor coalition than Delaware but still acquiescent in the political bargain that shifts the power to the states. The resulting image is of the SEC as "on standby";²³ it is essentially an intermediate appellate body, allowing Congress to be the court of last resort—and one that usually does not entertain jurisdiction. Because of this structure, other stakeholder interests are rarely offered the opportunity to win battles. Most of the time Congress will react to the emergence of some public outcry by pointing to the SEC and the states as its delegates and letting them respond, rather than considering the possibility of significant reform.

This strategy works, however, only if the SEC is sufficiently constrained in its behavior by external political pressures. The idea that the Commission is highly responsive to external influence has been taken up by John Coates, who sees the SEC in much the same terms as Roe sees Delaware.²⁴ Coates describes federal securities regulation as a structural device that insulates decision making from the influence of other stakeholders in times of scandal and trouble, operating as a political "circuit-breaker."²⁵ He argues that the SEC is keenly sensitive, through both congressional discipline and the career interests of key staff members, to external influence by managers, institutional investors, and the securities industry, and capable of reaching rational tradeoffs as a result. But because both its political structure and governing statute orient it almost exclusively toward "investor protection," the political voices of other stakeholders are predictably (and in Coates's view, helpfully) diminished. Significant delegation to the SEC makes it much harder for those other interests to capture policy during the relatively short windows when the public is angry enough to support them.²⁶

22. Roe, *supra* note 19, at 2523–26.

23. *Id.* at 2541. Although Roe's story mainly portrays the SEC as Congress's standby agent in the exercise of federal oversight, there are hints of another view closer to the critics' position that the SEC itself is the legacy of the populist impulses that bubble up during scandals and troubles. This was the setting in which the SEC was first created, and such impulses return periodically as the background to subsequent legislation, such as Sarbanes-Oxley or the Foreign Corrupt Practices Act, wherein the SEC's jurisdiction and authority spurt forward.

24. John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531 (2001).

25. *Id.* at 553–58.

26. *Id.* at 579–80.

This image of a strongly disciplined SEC suggests a possible addendum to Roe's account. The manager-investor coalition he describes indeed has reason to think that Delaware will be sensitive to their mutual interests and keep the law within the bargaining zone so that neither will be dissatisfied enough to seek political help from Washington. The group most often pointed to in public choice and capture theories, Wall Street, has no reason for such confidence, and reason for concern in those (many) places where its interests might diverge from either corporate managers or organized investors. An active mergers and acquisitions market is simply the most obvious example. That might be an explanation for something Roe leaves a bit unclear: precisely what the SEC is "on standby" for. Wall Street gains a voice on corporate governance matters through the SEC's ability to discipline Delaware, even if that authority is rarely exercised.

This, then, poses the most interesting open question about the behavior of the SEC: what is the balance between external and internal forces as an influence on its decision making? In turn, what are the key external forces? And to the extent that room is left for internal speculation by the SEC to affect policy, how do those perceptions and inferences emerge and evolve?

III. INSTITUTIONAL STRUCTURE

We begin with an institutional roadmap. The SEC takes the familiar form of an independent regulatory agency, meaning that it is governed by five Commissioners, two of whom must have a different political affiliation from the majority. The President appoints the Commissioners for five-year terms, and chooses which one is Chairman; by convention, at least, the ranking leaders on the Congressional committees with jurisdiction over securities play a key role in negotiating the appointments of the Commissioners who are not from the President's party. Importantly, the Chairman alone has authority over staff and resource issues: the choice of the key staff members (particularly the Division Directors) does not require the advice or consent of the other four.

From this, one would predict that the Chairman dominates the agenda, albeit with slightly moderated control. One fairly subtle factor also favoring the Chairman is that the "other" commissionerships are not necessarily so highly prized as to attract strong and powerful people; the pay is relatively low (substantially lower even than senior staff positions) and the position is power-limited, especially if one is from the minority party. Occasionally strong commissioners emerge—academics like Columbia's Harvey Goldschmidt or others who have already achieved

high levels of success and financial security—but in general the expertise and status of the “others” has been mixed in the last few decades. The main leverage of the other commissioners is their ability to blow the whistle when dissatisfied: to alert the press, lobbyists, or key allies in Congress when action is being taken (or not taken) that can be painted pejoratively.

The Chairman’s relative dominance increases the possibility of strong external political influence on the SEC. The chairmanship itself is at the behest of the White House, and the budget of the SEC, for which the Chairman has main responsibility, is for Congress and the President to set. And of course Congress can discipline the Chairman and the Commission through a variety of means besides the budget: oversight hearings, criticism in the press, and inter-agency competition, among others.²⁷

At the high staff level, a key institutional feature of the SEC is what seems to be a high turnover rate (how this compares with other agencies would be an interesting empirical project).²⁸ Senior staff members often come from partnerships in large law firms or comparable positions in business, stay for three or four years, and move back with substantially enhanced status and visibility. This, too, is consistent with considerable external influence on the Commission’s behavior, and less slack for bureaucratic discretion. While the SEC’s staff has its share of career bureaucrats, it is hardly dominated by inbred promotions to key policy-making positions. And when insiders do ascend, they often depart for the private sector after a few years, too.²⁹

This brief portrait suggests that Coates is reasonable in thinking that the SEC is responsive enough to external political influence that its policy should be tightly coupled with those influences. Yet this is not the standard account. Again, there is the long-standing critical perspective that the SEC habitually gets policy wrong because it is bureaucratically inbred and unresponsive. On the other hand, the SEC has many admirers who believe that it has generally resisted capture and heroically pursues a retail investor-oriented agenda in the face of all that external pressure. The question to which we now turn is whether either version (or something in between) is plausible, and if so, how.

27. See J.R. DeShazo & Jody Freeman, *Public Agencies as Lobbyists*, 105 COLUM. L. REV. 2217 (2005).

28. There was some data produced in the early 2000s in response to concerns about high turnover. See Anne Khademian, *The Securities and Exchange Commission: A Small Regulatory Agency with a Gargantuan Challenge*, 62 PUB. ADMIN. REV. 515, 521–22 (2002).

29. *Id.*

IV. THE PLAUSIBILITY OF LOOSE COUPLING

A. A Cautionary Note About Hidden Agendas

We turn now to the alternative hypothesis—that the SEC exercises autonomous or semi-autonomous discretion in its policy making rather than simply (or mainly) responding to the will of external political interests. Empirically, how might we know whether this is so? To many the proof is intuitive: the SEC appears often enough to act in a way that causes many key players to complain, certainly generates costs that these players have to incur, and on occasion takes visible enforcement action penalizing well-known companies, insiders, and securities firms fairly harshly. But this by itself is not inconsistent with capture by external political forces, for two familiar reasons.

First, as most law and economics scholars have long recognized, *some* baseline of securities regulation is economically efficient and thus will be demanded even by self-interested corporate managers. If investors have any degree of rationality at all and are capable of learning from experience, their participation in the capital marketplace will reflect their perception of the risks of investing in a setting characterized by informational asymmetries. Risk will be priced. And some collective mechanism will be sought by issuers, insiders, and the securities industry to reduce the cost of capital. Better companies will want protection from claims by “lemons” competing with them for capital, and by most accounts, market solutions will not solve the lemons problem entirely. The securities industry also benefits from reducing these risks, which should create deeper and more liquid markets.³⁰ Hence we could expect a reasonably vigorous antifraud program from the SEC even with general industry capture, and could imagine the same “good business” forces coalescing behind various kinds of mandatory disclosure requirements implemented by the SEC.

The preceding is a reasonably public-oriented account in terms of balancing entrepreneurial and investor interest, but there are also darker hypotheses to consider. As is well known in the public choice literature, regulation is often a way of allocating rents among competitors: a key industry (or segment) might demand regulation because even if it costs them a good bit, it costs competitors or potential competitors more. Critics of the SEC’s national market system initiatives claim that the regulatory

30. Khademian details in her book the work of the securities industry in strongly *opposing* budget cuts and staff cutbacks at the SEC during the 1980s. KHADEMIAN, *supra* note 10, at 172–75.

revisions favor the New York Stock Exchange or Nasdaq over electronic entrants; the implication is that the SEC is acting at the Exchange's bidding.³¹ Hedge fund regulation, another recent controversy,³² is strongly desired by hedge funds' more conventional and already heavily regulated competition, the mutual fund industry. Regulation of insider trading by corporate executives might benefit market insiders.³³ In all these instances, we observe heavy regulation, generating vocal complaints from many quarters, yet consistent with a public choice account. One can embellish by considering the possibility that members of Congress (or politicians generally) might want the SEC to threaten—and, to make the threat credible, occasionally follow through on—burdensome regulation so that they can exercise their ability to intervene and moderate the regulation in return for campaign contributions.

There is an alternative version of the public choice story that also might be consistent with anecdotal observation: that “heavy” SEC regulation is often more apparent than real, more dramaturgical than truly burdensome. Here, the SEC could be its own purveyor of the illusion that investor protection is of higher quality than it really is, which in turn could have two positive payoffs for key market participants. First, apparent regulation might create a greater degree of investor confidence than is warranted, especially if a large segment of investors are gullible enough or if new generations of investors emerge without having learned the previous generation's lessons.³⁴ Second, well-publicized regulatory action might provide a political buffer from more intrusive “actual” regulation when scandal or troubles provoke the public. A new round of illusory regulation can placate until memories fade and the market rights itself. John Coates's account is along these lines: there exists the appearance of heavy-handed SEC regulation when, in fact, the SEC creates ample opportunities to reduce regulatory costs (e.g., Rule 144A as an alternative to the registered public offering).³⁵ One can identify many SEC rules that could be forms of impression management. In the executive compensation area, the SEC pursues a disclosure-based strategy, ratcheting it upwards on occasion

31. See *infra* note 112.

32. For a good review of the hedge fund issue, specifically relating this to SEC judgment and decision making, see Troy Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style and Mission*, 2006 U. ILL. L. REV. 975 (2006).

33. See Haddock & Macey, *supra* note 18.

34. See Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777 (2000); Donald C. Langevoort, *Managing the “Expectations Gap” in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1165 (2003).

35. See Coates, *supra* note 24, at 548–49.

with substantial publicity, even though the empirical evidence shows little good coming from such an approach.³⁶ One inclined to public choice could easily see this as coming with the acquiescence of corporate insiders who want to deflect calls to control the apparent excess through more potent means. In the darkest version of this story, one could charge the SEC with deliberately doing public relations work for business, the securities industry, or Congress, hiding the true extent of opportunism and embedded conflicts via the pretense of expert regulation.³⁷

I am not endorsing any of the foregoing entirely, though I suspect that there is some truth to each, especially the first (I do not subscribe at all to the dark vision just mentioned, however). The simple point is that we should not take the fact of apparently intrusive regulation as sufficient evidence of SEC slack to act independently.

B. The Case for (Some) Slack

The case for the SEC as having some autonomous bargaining power proceeds in two directions, which need not be mutually exclusive. Again, both are well known in the political science literature; my aim here is to tie them specifically to the SEC's political ecology. The first is the idea that external pressure is pluralistic, and key interests neutralize each other so as to leave space for administrative discretion.³⁸ As is made clear by the foregoing, neither investor nor business interests are monolithic or coherent in their demands; public pension funds have a different agenda than do mutual funds, and retail investors and high tech companies often disagree with old-style industrials about disclosure issues (e.g., the expensing of stock options). Perhaps of greatest importance is the latent tension, noted earlier, between Wall Street and "Corporate America." While there may be many sources of agreement, there may be divergence between the interests of Wall Street and Corporate America, especially considering that the securities industry benefits from frequent transactions and market liquidity. Corporate takeovers is one issue where the conflict is

36. See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 53–62 (2004).

37. I am not suggesting that this is actually so. And even if many forms of regulation are window dressing, that is not necessarily bad if it has the effect of counteracting investor biases that would otherwise lead them to underinvest. See Amitai Aviram, *In Defense of Imperfect Compliance Programs*, 32 FLA. ST. U. L. REV. 763 (2005); see also Peter Huang, *Regulating Irrational Exuberance and Anxiety in the Securities Markets*, in *THE LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR* 501 (Francesco Paresi & Vernon Smith eds., 2005).

38. See KHADEMIAN, *supra* note 10, at 13–16.

apparent, and one can look at more subtle issues, such as shelf registration, where investment banks have had very different views of the SEC's proposals than have CFOs.³⁹ Sometimes potent political coalitions will form to bridge these differences, but that is far from certain, especially as the number of interested parties grows. And if not, the SEC faces political uncertainty; it has to choose to act (or not act) knowing that there will be a mix of political costs to pay but offsetting benefits to be gained, but not knowing with any clarity what the optimal strategy is. Therein is substantial room for discretion.

We should also at least consider the possibility that the public and retail investors have somewhat more latent political influence than the standard public choice account allows, and are not so gullible that mere window dressing regulation suffices. The growth of market-based retirement savings and other broad share ownership in the United States, coupled with the explosion in the financial media of coverage of investor-related matters, suggests that the “median voter” might find regulatory issues more salient than otherwise expected. That is to say, the frequency of scandals and other forms of “trouble” may be increasing in ways that the regulators could draw from for bargaining strength. Certainly we see political efforts by regulators to make these connections—Arthur Levitt's town meeting and other outreach initiatives in the 1990s may be an example,⁴⁰ as is Eliot Spitzer's crusading in New York on a more local (at least for the time being) political level.⁴¹ I have argued elsewhere that the SEC's campaign against insider trading is really the creation of a “brand” of securities regulation that is partially explainable in terms of garnering public support and, hence, political leverage.⁴² The idea here is hardly that investor empowerment produces a high degree of agency autonomy, but rather that it may produce just enough that the SEC's negotiations with external political forces are not completely one-sided. This line of reasoning, too, leaves room for some discretionary behavior.

The second story regarding “slack” is more classical. Bureaucracies have autonomy, it is often said, simply because the disciplinary weapons that external political forces might wield are imperfect, even when the pressure is well organized.⁴³ Civil service protections immunize many

39. *Id.* at 15.

40. See SELIGMAN, *supra* note 10, at 629–30.

41. See Jonathan R. Macey, *Wall Street in Turmoil: State-Federal Relations Post-Eliot Spitzer*, 70 BROOK. L. REV. 117 (2004).

42. Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1328–29 (1999).

43. See ANTHONY DOWNS, *INSIDE BUREAUCRACY* 132–43 (1967).

agency insiders from career threats, and these insiders can influence policy making because of their control over information and the regulatory agenda. We might draw from the lessons of organizational behavior, which teach that firm-level preferences and top-down initiatives are often blunted by resistance from managers, even in firms that must compete in markets and thereby suffer from these agency costs. This should be all the more true in a government agency operating in a non-competitive setting. Agency costs within governmental agencies, then, *must* be something of an issue.⁴⁴ If so, then we should expect to observe outcomes that diverge from what even the agency itself, if we imagine it anthropomorphically, would consider to be in its best interest. The two “slack” stories connect, of course: the more pluralistic and disorganized the external political influences, the more bureaucratic autonomy (in the form of agency costs or otherwise) we are likely to see. This seems to be the motivating assumption of the SEC’s strongest critics, and we now explore these possibilities in more depth.

C. Internal Motivations

If we think that internal motivations have some role in the formulation of SEC regulation, the obvious question becomes one of content. Once again, there are two competing formulations typically offered. One, building from the agency-cost perspective, is that SEC decisions reflect the self-interest of key players within the Commission. The other is that these decisions reflect key players’ rational and/or ideological normative beliefs about appropriate regulation.

1. The Agency-Cost Perspective

A commonplace heuristic for the first formulation is the argument that the SEC consistently seeks to expand its own “turf” in terms of jurisdiction and resources; when the SEC does not succeed, it is only because of external constraints. One question about this claim, however, is whether it adequately takes account of the career horizons of those most likely to influence internal SEC decisions. As noted earlier, both Commissioners and senior staff frequently come from outside the agency—and return fairly soon (or depart if they rose internally). Agency-cost theory focusing on the business firm has determined fairly convincingly that time horizons matter greatly in the manifesting of self-

44. See Terry M. Moe, *The New Economics of Organization*, 28 AM. J. POL. SCI. 739 (1984).

serving behavior. For example, corporate candor in financial reporting has close ties to compensation arrangements and promotion opportunities, so that there will often be a sacrifice of long-term institutional value in favor of short-run self-interest.⁴⁵ If the locus of decision making at the SEC is high-up, then we might suspect that the better measure of self-interest from an agency-cost perspective is career value outside the SEC, rather than maximization of the agency's longer-term jurisdiction and resources.

Such a shift in focus might yield interesting insights. If we believe that the Chairman dominates internal decision making, then we would want to examine the long line of Chairmen to see what they did after leaving the SEC and how they might have benefited (or suffered) from the decisions made while they were Chairman. Is SEC decision making affected when the Chairman has already built a great deal of wealth and the chairmanship is largely the public capstone of a private career, as with the two most recently departed Chairmen, Arthur Levitt and William Donaldson?

If, as is more commonly argued, the senior staff are the real loci of policy formulation, then career effects should be even more compelling. The move from division director (or even associate director) to private law practice is typically celebrated in the trade press as creating immediate wealth and stature. A frequent concern associated with the "revolving door" is that agency insiders will do the bidding of firms and their clients, who will repay them for their loyalty later on—and there may well be truth here. My own observations, however, suggest something else, which relates back to the earlier interest group analysis. In conventional economic contracting terms, the agency insider who delivers regulation of value (which, remember, is not necessarily *less* regulation) to future employers and/or clients is exposed to a hold-up risk; the goods are already delivered before the payback period starts. And many others can free-ride on their work. An alternative strategy would be to develop dense, difficult regulation over which the insider has superior expertise, giving the insider a competitive advantage once in private practice, in both interpreting the regulation and influencing its interpretation by others (including one's former colleagues still on the SEC staff). This would seem to be a sounder rent-seeking strategy.

If this were systematically to occur, we would see the overproduction of law and too-frequent change for the sake of change, which is indeed a criticism frequently made of SEC regulation. One might then expect some

45. See, e.g., John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3 (2005); Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 1 (2005).

push-back from the key external interests who suffer as a result. This response would vary in effectiveness depending on the particular political ecology surrounding the agency action. (Dense regulation would not be strongly resisted, for example, by larger firms if they thought that smaller competitors would have a harder time with compliance.)

And here it is worth adding a peculiar interest group to the mix: lawyers.⁴⁶ Although securities lawyers take on many of the attitudes and beliefs of their private sector clients, there is always a subtle conflict present.⁴⁷ The more difficult and complex the law is, the more valuable (and necessary) lawyers' services are. On average, the legal profession will support rather than oppose regulatory change that is likely to generate more business, meaning that high level agency insiders may find willing political allies for re-regulation among their colleagues in private practice, apart from any other costs and benefits that the change creates.⁴⁸

In addition, the private bar has strong influence over SEC policy, especially at the senior staff level. There are informal contacts (recall that many senior staff come from private practice, and presumably maintain those social and professional networks), as well as more formal contacts, such as groups like the ABA's Committee on the Federal Regulation of Securities, that play a very active lobbying role and are heavily populated by former SEC staff. One empirical prediction is that the preferences of elite lawyers outside the SEC will influence the strategic choices of the senior staff, and these preferences will ebb and flow over time. The appeal of re-regulation will be weakest when elite lawyers already have expert control over the law, additional changes will have diminishing marginal returns (or perhaps negative returns). By contrast, the appeal of re-regulation will be strong when a new class of elite lawyers emerges who would use the opportunity of significant regulatory change to wrest market power from the older generation. Hence another potentially testable empirical prediction is that the younger the senior staff members going

46. See KHADEMIAN, *supra* note 10, at 89–91 (noting that, at least in the 1980s, over 60 percent of the SEC's professional staff was made up of lawyers, as was more than 70 percent of its commissioners). The role of lawyers in the production of corporate law is frequently examined. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

47. See Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 377–78 (1997).

48. This tendency may link the lawyer-based account to the more conventional view that bureaucrats seek to enlarge their power and resources: career-oriented insiders with a short time horizon might nonetheless fight for expanded bureaucratic turf because that expansion eventually redounds to their benefit once in private practice.

through the revolving door, the more likely this kind of re-regulation will be.

2. *Ideology and Normative Beliefs: Internal Agency Culture*

Stated most starkly, the foregoing account describes career-oriented behavior that is wholly disconnected from any perceptions of the public interest, except to the extent that external political demands happen to coincide with good regulation. Most observers (other than ultra-orthodox economists) doubt that this is so and offer alternative explanations for how the SEC behaves, wherein ideology and normative beliefs do strongly affect discretionary agency behavior.⁴⁹ While one can explore this hypothesis in terms of the judgment and decision making of key individuals, most students of organizations prefer to look to internal culture as the source of shared sense-making.⁵⁰

The challenge in this line of inquiry comes from seeing that securities regulation, like so many regulatory tasks, is done under circumstances of profound ambiguity. Although research in finance and economics, to which the SEC has not always paid the closest attention, has produced greater knowledge of investor and market behavior, there are still strong disagreements about even baseline questions: How rational are investors? How and when do they process the information that securities regulation forces? To what extent do agency costs distort prices and trading behavior? When do markets counteract individual biases and when do markets enhance individual biases?⁵¹ Some of this uncertainty is simply a matter of empirical deficit, but because the capital markets are so dynamic, even empirical evidence that becomes available can quickly go stale. All but the most committed behavioralists concede that market institutions have the capacity to learn and adjust, if not as quickly as strong efficiency-theorists would like.⁵² But constant innovation in the form of new financial products and market mechanisms, coupled with fluctuations in exogenous economic conditions and emergent generations of new

49. See, e.g., Roberta Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005).

50. See, e.g., KARL E. WEICK, *SENSEMAKING IN ORGANIZATIONS* 127–31 (1995); see also Donald C. Langevoort, *Opening the Black Box of “Corporate Culture” in Law and Economics*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 1 (2006).

51. See Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 152–54 (2002).

52. See, e.g., Mark Rubenstein, *Rational Markets—Yes or No?*, FIN. ANALYSTS J., May–June 2001, at 15.

investors, persistently generate new questions and render old assumptions obsolete. If there is one thing we know about organizational cultures, it is that they seek to impose cognitive order, “sense-making,” on uncertainty in order to facilitate productive activity. They simplify and explain, usually well beyond what scientific knowledge would allow. The purpose of the inevitable distortion of reality is the avoidance of epistemic despair; simplification allows work to get done. Many scholars (including me) have suggested that simplifying organizational cultures can be quite adaptive, even when partially built on illusions.⁵³

We should expect the SEC to have developed a sense-making culture, although its strength might be moderated because of relatively high rates of staff turnover. But predicting that a culture exists leaves us far short of knowing what the substantive content of that culture is likely to be. One empirical research project that would be extraordinarily valuable would be to gather data testing perceptions of key aspects of investor, managerial, and market behavior by SEC staff compared to other sample populations. A well-designed survey or ethnographic study could tell us how coherent or distinctive these perceptions are within the agency.

Short of such a study, we can only speculate about the internal culture and how it might affect the SEC’s judgment and decision making in responding to ambiguous policy matters. Here, again, there are alternative hypotheses to consider. One could take an historical view and say that the contemporary culture is a legacy of the SEC’s past. The agency was founded as part of the New Deal’s enthusiastic experimentation with government intervention in the economy, its earliest days marked by crusader-like beliefs of the sort William Douglas and Joseph Kennedy espoused.⁵⁴ This oppositionalism (or at least distinctive self-identity compared to the subjects of regulation) might have been bolstered by recruitment patterns, in terms of both self-selection by regulatory idealists and exclusionary practices elsewhere. As to the latter, an intriguing feature of SEC history is the extent to which it welcomed lawyers and other professionals (Jews in particular) who were excluded because of discrimination by “white-shoe” firms in the 1940s and ’50s that represented elite business interests.⁵⁵ One could imagine that therein could be the source of in-group myths that portray in more vivid shades of dark

53. See Langevoort, *supra* note 50.

54. See SELIGMAN, *supra* note 10, at 104–23, 189–214.

55. See LOUIS LOSS, ANECDOTES OF A SECURITIES LAWYER 28–29 (1995). This is a common theme in the history of this period. See Jerold S. Auerbach, *From Rags to Riches: The Legal Profession, Social Mobility and the American Jewish Experience*, 66 AM. JEWISH HIST. Q. 249 (1976).

and light the good of regulation and the bad of industry opportunism. Distinctive “pride” in the work of the agency is frequently expressed in oral histories, especially as they relate to what many see as the “golden age” of the SEC—from the early 1960s through either (and there would be vigorous argument about this) the 1970s or ’80s.⁵⁶ A substantial nostalgia drives recollections of the days of Manny Cohen, Stanley Sporkin, Irving Pollack, Milton Cohen, Phil Loomis, and Al Sommer, whose progeny still populate the securities bar’s elite. Perhaps that nostalgia still generates a strong self-identity within the SEC, helping the motivational work⁵⁷ and leading to outcomes consistent with a genuine desire to help investors.

The nostalgia theory is plausible, although I would not want to overstate the path dependency aspect of the story as it might apply today. Indeed, many of those who offer some version of that account do so with regret for the seeming demise of the SEC’s spirit in the last decade or so, and it is entirely possible that these myths were for external consumption and never strongly believed inside the agency even back then. To seek a bit more currency, we might think generally about what kinds of collective perceptions and inferences are likely to emerge and be validated. We could perhaps turn to the cognitive psychology literature for help, as this subject has begun to interest both administrative law⁵⁸ and securities scholars. Among the latter, Steve Choi and Adam Pritchard have made a particularly strong claim that commonplace behavioral biases are likely to infect SEC decision making so as to justify a presumption against regulatory intervention.⁵⁹

Care must be taken when invoking the judgment and decision literature in organizational settings; administrative decision processes vary substantially from how a single individual might react to a choice, and

56. See SELIGMAN, *supra* note 10, at 568 (“As the Commission neared completion of its first half-century, its reputation as ‘an outstanding example of the independent commission at its best’ remained intact”). The mid-1980s are more controversial. While certain SEC policies are debatable depending on one’s ideology, this was a period of impressive staff performance. See *id.* at 576–77. A notably successful insider trading enforcement campaign occurred during this period as well. See *infra* text accompanying notes 101–02.

57. See George A. Akerlof & Rachel E. Kranton, *Identity and the Economics of Organizations*, 19 J. ECON. PERSP. 9 (2005).

58. See, e.g., Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549 (2001); Mark Seidenfeld, *The Psychology of Accountability and Political Review of Agency Rules*, 51 DUKE L.J. 1059 (2001); Stephanie Stern, *Cognitive Consistency: Theory Maintenance and Administrative Rulemaking*, 63 U. PITT. L. REV. 589 (2001).

59. Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003); see also Stephen J. Choi, *Behavioral Economics and the Regulation of Public Offerings*, 10 LEWIS & CLARK L. REV. 85 (2006).

even individuals vary considerably and do better when prompted to engage in higher-level thought processing. That said, there is good reason to suspect that certain heuristics have as much or even greater potency in organizations than in individuals.⁶⁰ On the purely cognitive side, for example, people place too much weight on what is immediately available and salient, overestimating its frequency within the universe of possibilities compared to what is less available or salient. This bias is subject to an organizational corrective (collecting information from more than one source), but the corrective is limited by the scope of the organization's gaze. Thus, an agency like the SEC that seeks out and looks for abuses is unlikely to do well at estimating the frequency of abuse, since it finds many abuses and tends to pay no sustained attention to the absence of abuses.⁶¹ Another heuristic is being slow to recognize and adjust to change (cognitive conservatism). This would suggest, with some plausibility, that the SEC will fight old wars longer than it should, and enter new battles too late.

We are losing traction here, however, because it is impossible to predict how commonplace or deep these heuristics might be or how they might affect any given choice. Most obviously, outside interests are strongly motivated to bring contra-indications to the attention of the staff and Commissioners, which is usually an effective de-biasing technique. Maybe this outside criticism is too easily dismissed by the Commissioners and staff ("reactive devaluation," in psychological terms), but we cannot be sure. Again, the fact that the SEC has such loose borders because of the entry and exit of key staff makes it implausible that culturally-determined cognitive blinders are put on promptly upon arrival at the SEC and kept firmly in place for the duration of what is often a short stay.

Related to this is an idea that Roberta Romano has invoked with respect to the legislative process: ambiguity as to the right course of action leads to excessive reliance on external sources of expertise.⁶² That is all well and good if the expertise is there, but there are many who cloak themselves as experts but pursue agendas poorly grounded in empirical evidence. The inability to distinguish between high- and low- quality "norms entrepreneurs" may unduly affect regulatory outcomes; the SEC's internal practice may be to accept the advice because it generates

60. For a detailed discussion, see Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 102–04 (1997).

61. Choi & Pritchard, *supra* note 59, at 25–26.

62. See Romano, *supra* note 6, at 1568–69.

superficially appealing, confident predictions, which buffer the angst of uncertainty.⁶³

Perhaps the most intriguing possibility is that the culture takes on a self-serving character, causing perceptions and inferences that comfortably coincide with career interests.⁶⁴ Securities regulation is highly dependent, at least in its current form, on the twin perceptions that investors are on average unsophisticated enough to justify regulatory intervention, and that they will process the disclosure that regulation forces in a way that leads to good decision making. The SEC has never showed much interest in the question empirically, even though there is a latent tension between the two assumptions (are unsophisticated investors really likely to process disclosure well?⁶⁵). One explanation is that, like many persons and groups, the SEC has generated a hard cultural shell of resistance to evidence that might disconfirm its longstanding self-identity.⁶⁶ And because it is a lawyer-dominated agency, the loose boundaries of the SEC make it less likely that this kind of bias will be countered. Securities lawyers generally, inside and outside the agency, may be motivated to see more value to regulation than there really is,⁶⁷ because they have expertise that generates rents and are motivated to see legitimacy in that to which they have committed their (lucrative) careers. To test this proposition, I would be curious whether there is a good empirical measure for lawyer-dominated agencies compared to others and, if so, whether there is any correlation with the frequency or type of regulation.

The point here is not to conclude that the SEC cannot or does not pursue public or investor interests well. My much more moderate claim is that because too little is known about the costs and benefits of regulation, there is an empty space that is filled by speculation and conjecture, but those inside the agency are likely to interpret this conjecture with unwarranted confidence by drawing on shared assumptions and efforts to “make sense” of things. A corollary of this claim is that one can observe,

63. This idea has roots in both sociology and social psychology. In the former, it is expressed in the literature on “mimetic” processes by which actors, confronted with uncertainty, conform to the behavior of influential others who appear, rightly or not, to have an answer to how to proceed. See, e.g., Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. REV. SOC. 147, 151 (1983).

64. See Langevoort, *supra* note 8, at 531–32.

65. This lack of sophistication stems from both their own biases and their limited attention capacity. On the latter, see Troy A. Paredes, *Blinded by the Light: Information Overload and its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 437–43 (2003).

66. See Choi & Pritchard, *supra* note 59, at 30–32; Langevoort, *supra* note 51, at 173.

67. This is a theme of one of the most famous academic critiques of the SEC. HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 4, 18–20 (1979).

as most do, that the SEC and its staff are populated by smart, hard-working, and well-intentioned professionals, yet still worry about the risk of inaccurate collective judgment.⁶⁸

From this perspective, if there is a particular collective goal that drives the internal culture of the SEC, consciously or not, it is likely to be loss aversion, which can be expressed both as a common psychological bias and a normative heuristic—the precautionary principle.⁶⁹ As noted earlier, reputational payoffs to key SEC officials are asymmetric: good economic outcomes (e.g., lowering the cost of capital or creating more competitive markets) are hard for the SEC to take credit for, while bad ones (e.g., scandals and troubles) generate intense criticism. Publicly and politically, there is a tendency to draw spurious associations between agency deregulatory actions (or inaction) and scandals. This tendency is threatening both externally, in terms of explaining to the public why the SEC merits investor confidence, and culturally, in terms of maintaining the myth-stories that generate internal cohesion. This kind of fear could well overcome external deregulatory pressures, especially if key outside interests, such as members of Congress or industry participants, share the belief that scandal and trouble could cause them to lose control of the political agenda.⁷⁰

So far, the behavioral possibilities I have put forth are mainly functionalist—those that can be considered with respect to the work they do of aligning the SEC's actions either with external pressures, or the demands of internal cohesion or self-interest. Many sociologists of organizational behavior would warn against excessive functionalism, however, and predict that the SEC's culture may be more a product of the diffusion of general social/cultural norms than anything strong or unique to the agency.⁷¹ Hence I want to raise one more possibility for further study. It is possible that, over time, the institutional commitment to the

68. For an interesting account of an award-winning government authority that gradually blinds itself to the consequences of its own behavioral practices, see Paul F. Levy, *The Nut Island Effect: When Good Teams Go Wrong*, 79 HARV. BUS. REV. 51 (2001).

69. See Cass R. Sunstein, *Beyond the Precautionary Principle*, 151 U. PA. L. REV. 1003 (2003). For a criticism of its application to SEC decision making, see Paredes, *supra* note 65.

70. Khademian points to a great deal of loss aversion on the part of both Congress and lobbyists that leads them to support the SEC's investor-protection work: "No politician wants to be associated with a downturn in the markets or, worse, a downturn in the economy. In the securities industry, economic fortunes ride on the psychology of investor confidence, and misstatements or inexperienced ventures into policy making could spell election-time disaster for committee members." KHADEMIAN, *supra* note 10, at 12.

71. See Lauren B. Edelman & Mark C. Suchman, *The Legal Environments of Organizations*, 23 ANN. REV. SOC. 479, 481–84 (1997).

received model of investor protection has in fact weakened. Intellectually, the myths described earlier have been challenged for at least three decades, and new generations of regulators are likely familiar with the criticisms.⁷² Perhaps there has been a loss of faith. If so, what takes its place motivationally? An alternative to a simple self-interest story is that other values have seeped in. One well-recognized possibility is that there has been a growing public demand for accountability from those with economic power, with less concern for older public-private boundaries. (The regulatory reaction to Enron, for example, might have been far less about securities regulation per se than public anger that associated the well-publicized social and economic losses to accounts of arrogance and greed.⁷³) If so, we might wonder whether the SEC's culture today has reimagined "transparency" as less about delivering valuable information to investors, and more about inducing public accountability in heretofore private domains.

V. A BRIEF CASE STUDY: MUTUAL FUND GOVERNANCE

As noted earlier, in 2003 there was a set of scandals in the mutual fund industry—a \$7 trillion business in which many people had invested much of their retirement savings—upon discovery that some fund managers permitted outsiders (and occasionally themselves) to engage in late trading and market timing in return for investments that would increase the managers' advisory fees.⁷⁴ These scandals were unsettling politically because they were not uncovered by the SEC but by Eliot Spitzer, who criticized the agency's sleepiness, and because they came shortly after the Enron and Worldcom scandals, which had already led to questions about the SEC's effectiveness and commitment. The SEC responded by adjusting certain key exemptions under mutual fund regulations so that mutual fund boards would have to be made up of at least 75 percent outside directors (as opposed to 50 percent), have an independent chair, and be given sufficient resources (such as independent counsel) to arrive at

72. On the impact of criticism in other agencies, see MARTHA DERTHICK & PAUL QUIRK, *THE POLITICS OF DEREGULATION* 246 (1985); as to the SEC, see Donald C. Langevoort, *Theories, Assumptions and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 888 (1991).

73. In such cases, the measures of benefits and costs would be different from standard "cost of capital" empiricism. On the application of this idea to the internal controls controversy post Sarbanes-Oxley, see Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting "Duty of Care as Responsibility for Systems"*, 31 J. CORP. L. 949, 964–65 (2006).

74. See Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161, 168–69 (2004).

better oversight. The rule was supported by the Chairman (a Republican) and the two Democrats on the Commission, and opposed by the two other Republicans.⁷⁵ This rule was struck down, at least initially, by the D.C. Circuit on cost-benefit grounds;⁷⁶ that is, the SEC had not looked closely enough at certain likely costs, and it did not give specific attention to the disclosure-based alternative being pushed by the dissenters.

My interest here is, first, to try to figure out why the SEC would adopt such a rule. We have its explanation in the proposing and adopting releases, as well as the court's expression of dissatisfaction with it; I want to draw on the foregoing material to see how well the possible explanations connect to the various accounts of SEC behavior we have considered. At least tentatively, I also want to think about the administrative law issue. What would be the likely consequences of more rigorous insistence on cost-benefit analysis (that is, at a serious level of economic proof) as a constraint on SEC lawmaking?⁷⁷

We should look first for an external political account. On its face, the regulation suggests something that public choice theory would doubt: retail investor demand actually trumping organized opposition. In addition, the mutual fund industry has competitors (e.g., exchange-traded funds, hedge funds, and other financial institutions) that might want to burden it for selfish reasons, and thus might support the regulation as well. Another possibility is that the mutual fund industry invited the regulation as a precautionary technique: fearing the political fallout from the scandal, especially if it persisted or deepened, the industry acquiesced in mild but "showy" governance reforms. Note that it was the Chamber of Commerce that challenged the rule, not the mutual fund industry's trade group, the Investment Company Institute (ICI).⁷⁸

Internally, we have a different set of possibilities. One could, of course, accept the SEC's public interest story that in its expert opinion a higher

75. See *Divided SEC Adopts Rules Requiring Independent Chairman*, 36 SEC. REG. & L. REP. (BNA) 1154 (June 28, 2004).

76. Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

77. A number of recent papers have taken up this issue, with specific reference to the mutual fund governance rules. See David S. Ruder, *Balancing Investor Protection with Capital Formation Needs After the SEC Chamber of Commerce Case*, 26 PACE L. REV. 39 (2005); Peter H. Huang, *Beyond Cost-Benefit Analysis in Financial Regulation: Process Concerns and Emotional Impact Analysis* (Inst. for Advanced Stud. Soc. Sci. Econ., Working Paper No. 62, 2006), available at www.ssrn.com/abstract=870453.

78. We should not overstate the importance of this fact, however, because the ICI did officially oppose the rule and trade groups do not usually sue the agency that has day-to-day supervisory responsibility over its industry. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Mar. 10, 2004), available at http://www.ici.org/statements/cmltr/2004/04_sec_gov_com.html.

percentage of independent directors would generate value for fund shareholders. Or it could be a crude “tit for tat” strategy—a punishment of the industry as a whole for not engaging in enough self-monitoring, thereby embarrassing the SEC—and a reminder to do better next time. Alternatively, the regulations could be an institutional defense mechanism: an artificially constructed (and perhaps misguided) response to regain public, political, and internal respect by a public display of activity, regardless of the activity’s substance. The latter two accounts are bolstered by the SEC’s obvious discomfort that Eliot Spitzer had uncovered these problems two years earlier with evidence of biased recommendations among certain investment analysts to enhance their firms’ investment banking prospects.⁷⁹

The SEC’s justification for the rule was inferential rather than empirical. In assessing likely benefits, it essentially reasoned: (1) that independent directors played a crucial role in monitoring self-interested fund managers (something that both Congress and the SEC have repeatedly said); (2) that increasing the directors via greater numbers and an independent chair was likely to result in better monitoring; and (3) that the recent scandals showed that better monitoring was important. Critics, whose main target seems to have been the independent chair requirement, made a number of complaints about this logic, even though they had to concede step (1) with respect to having *some* independent directors because it was firmly embedded in the 1940 Act. The charges were essentially that there was no showing to support the determination that the scandals were board-level failures; that the empirical data did not offer support, and indeed might cast doubt, on whether significant benefits flow from marginal increases in the number of outside directors or having an independent chair; and that the majority substantially underestimated the costs of shifting to greater independence, especially if an independent chair emerged (armed with an expensive independent staff) as a competing power base that would make policy issues much more contestable and decision making less efficient.⁸⁰ The two dissenting commissioners offered an alternative proposal in the form of market-based experimentalism: cast more light on governance via disclosure, and see whether investors value independence enough to favor funds with

79. See, e.g., Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 273–74 & n.12 (2003).

80. See, e.g., Martin E. Lybecker, *Enhanced Corporate Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration*, 83 WASH U. L.Q. 1045, 1084–87 (2005).

independent super-majorities or chairs.⁸¹ If they do, money will flow to them. If not, it is proof that independence is of little perceived value.

The style of thought underlying the SEC's judgment is plainly that of a lawyer rather than an economist, meaning that it is a perfectly reasonable-sounding argument instead of tightly-controlled, evidence-based analysis. That is hardly surprising given the lawyer domination at the SEC,⁸² but leads us back to questions about why empiricism plays such a small role in lawyer-style analysis at the SEC apart from the obvious one; whether lawyers have socially constructed a preferred style of deliberation in order to maintain their hegemony over SEC decision making. To this end, one can think of many fairly deep reasons about how lawyers are trained and socialized, with which I sympathize, but we would wander too far from the main subject of the paper by exploring them in depth. Moreover, there is a more parsimonious resource-based explanation for the SEC's lack of empiricism: the SEC may reasonably be devoting its scarce resources to fighting the fires surrounding it rather than investing in a deeper knowledge base with, at best, long-term payoffs. And again, there is also the possibility that deeply embedded in the SEC's internal culture is a disinclination to know too much in ways that would destabilize beliefs that are adaptive in maintaining organizational coherence. (I acknowledge that this might be a repetition of the hegemony point made earlier if we think that the coherence is just a reflection of how the lawyers want the SEC to be.)

Let's return to the mutual fund governance rule and consider the state of the economic knowledge from which the SEC might have drawn. By way of background, understand that the move toward independent "monitoring" directors in corporations generally has been a major empirical project, which in general has not delivered the results one would expect; it is difficult to find strong evidence that increasing the number of independent directors systematically generates positive returns for investors.⁸³ There are a number of possible reasons for this difficulty, all of which have been explored in great detail. One likely candidate is that the term "independent director" is ill-defined, so that most legalistic definitions allow for directors who are economically independent but

81. See Investment Company Governance, *supra* note 12.

82. Khademian quotes a former SEC lawyer: "Theoretical economics has very little to do with the commission's work. The SEC deals with investor confidence, and economic theory has nothing to do with investor confidence." KHADEMIAN, *supra* note 10, at 163.

83. See Sanjay Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999).

socially or psychologically close to the managers—meaning that high-powered monitoring will still not occur.

Elsewhere, I have cautioned against drawing too close an analogy between mutual fund corporate governance questions and those of other kinds of firms,⁸⁴ though plainly the definitional concern alluded to applies in both settings. There is a much smaller set of data dealing with mutual fund governance, but it contains a few nuggets from which the SEC could have found empirical support to bolster its judgment (though it is not clear how accessible this data was to the staff in the midst of the rule-making). One study, for instance, shows that the few boards all or mostly made up of independent directors are somewhat quicker to merge poor-performing funds into better performing ones, from which the economist-authors glean mild support for the kind of regulation the SEC has pursued.⁸⁵ One cannot draw too much from this, however, because those funds forced by rule to increase their outsider percentage might be particularly inclined to find “technically independent but friendly” directors that are no more likely to monitor aggressively than independent directors currently in place. Nor does it answer the cost question very well, for two reasons. First, it is hard to design a test of the likelihood of “true” independent blocs emerging under the leadership of an independent chair. Second, it is difficult to ascertain, or what the tradeoff between better monitoring and increased expense and internal conflict might be in terms of shareholder returns if an independent bloc did emerge. Still, one has to wonder why the SEC did not make more use of the available supporting data even if it fell short of clinching its case.

Instead, the majority’s approach was educated guesswork. Certainly, one could not glean from the data that they were *wrong* to demand more independence. But, at best, the data would support the idea that it was somewhat of a risky regulatory bet; it might deliver positive payoffs, but it might not. Conceding that, however, would have played into the dissenters’ hands. In the face of uncertainty, why not take the more

84. Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1030–32 (2005).

85. Ajay Khorana et al., *Board Structure, Mergers and Shareholder Wealth: A Study of the Mutual Fund Industry*, J. FIN. ECON. (forthcoming 2007). Some support can also be gleaned from Peter Tufano & Matthew Sevick, *Board Structure and Fee-Setting in the U.S. Mutual Fund Industry*, 46 J. FIN. ECON. 321 (1997), which is cited by the SEC in its proposing release and shows that more independent directors are associated with lower fees. Even the SEC acknowledged, however, that these studies neither claim nor establish that independent directors create any observed added-value.

moderate step of letting mutual fund investors decide, with better disclosure, about fund governance?

On this question, however, we know a bit more that might give us pause. In the absence of arbitrage opportunities, the market for mutual fund shares lacks strong efficiency properties.⁸⁶ On average, fund investors are hypersensitive to some disclosures and inattentive to others, and the market segments into products that appeal to more and less sophisticated shareholders.⁸⁷ In fact, investors withdrew a considerable amount of money from funds charged with significant wrongdoing.⁸⁸ There is ample reason to suspect investor insensitivity to more subtle disclosures about things like board makeup, which would support fear of residual opportunism in the market.⁸⁹ If so, the dissent's test would have a predictable outcome; some portion of the market might respond, though there is already a good bit of transparency about fund governance so that the more sophisticated have already figured things out and adjusted their portfolios accordingly. The less sophisticated end of the market would be unlikely to respond as hoped.

So why wouldn't the SEC seize on this possible market failure as supporting its position, instead of saying virtually nothing about the alternative, which ultimately became the main ground on which the D.C. Circuit first rebuked it?⁹⁰ There are two possibilities that connect closely to the theme of my paper. One is that seizing on this would make clear the paternalistic grounds for the regulation, an admission that is problematic in a political environment where free market rhetoric and ideology dominate. The other possibility is that emphasizing investor "irrationality" in making mutual fund choices threatens the belief system, on which so much of orthodox securities regulation rests, that investors take advantage of the

86. See Edwin Elton et al., *Are Investors Rational? Choices Among Index Funds*, 59 J. FIN. 261 (2004).

87. See Brad M. Barber et al., *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095 (2005); Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937 (2000); Mahoney, *supra* note 74, at 168. For suggestions for improvement, see James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907 (2005).

88. See Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals* (NYU L. & Econ., Working paper No. 06-07, Jan. 2006), available at www.ssrn.com/abstract=877896. As Choi and Kahan point out, this indicates the presence of a discipline that might make other regulatory responses less necessary. *Id.*

89. Choi and Kahan find no evidence that the outflows were affected by any governance changes in the funds involved. *See id.*

90. Indeed, it did not do so even after remand by the D.C. Circuit, in its second opportunity to justify the rule. *See Investment Company Governance*, *supra* note 14.

disclosures that SEC requirements generate.⁹¹ Indeed, the notion of investor irrationality may be threatening enough that it is something that the SEC's internal culture rules out of bounds in terms of how policy is legitimately considered within the agency.

Shifting back to the D.C. Circuit's initial opinion, most of it is quite favorable to the SEC, and rejects more of the Chamber's claims than it agrees with. Importantly, the court said that agencies like the SEC are permitted to speculate as to costs and benefits, as long as they explain their guesses in reasoned terms. Benefits like promoting "investor confidence," which economics-oriented scholars despise because they are so hard to measure, can presumably be considered in this calculation. And most significantly, the court said that there is no requirement that the SEC engage in or invoke empirical research in rulemaking such as this,⁹² even though the particular statute governing this kind of rulemaking requires consideration of a proposed rule's impact on efficiency, competition, and capital formation in addition to its effect on investor protection.⁹³

The court's decision was very much in the vein of contemporary administrative law that sees judicial review as something of a public dialogue with the agency, forcing out of it more care and candor as a counterweight to bureaucratic tendencies of the sort we have reviewed.⁹⁴ But the main point on which the court reversed the SEC shows the potential for such an approach if pursued aggressively. By focusing on costs (and less costly alternatives) rather than benefits, the court looked to the side where empirical work is more likely to be available but that an agency, having decided it wants the rule, is likely to slight.⁹⁵ There are

91. See Langevoort, *supra* note 51, at 173.

92. Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133, 142 (D.C. Cir. 2005) ("[W]e are acutely aware that an agency need not—indeed cannot—base its every action upon empirical data; depending on the nature of the problem, an agency may be 'entitled to conduct . . . a general analysis based on informed conjecture'", quoting *Melcher v. FCC*, 134 F.3d 1143, 1158 (D.C. Cir. 1998)).

93. Section 2(c) of the Investment Company Act, 15 U.S.C. § 80(a) (2000), along with identical language in the other securities statutes, requires that these factors be taken into account whenever the SEC is required to base its rulemaking on "public interest" considerations. While that was clearly the case with respect to exemptive rules under the Investment Company Act, there are many important grants of rulemaking authority that allow justification based on either the public interest *or* investor protection. See, e.g., Section 13(a) of the Securities Exchange Act, 15 U.S.C. § 78(c) (2000) (the basic grant of authority over corporate disclosure). If the latter, the "efficiency, competition, and capital formation" overlay would technically not apply. 15 U.S.C. § 77(b) (2000).

94. See Jonathan T. Molot, *The Judicial Perspective in the Administrative State: Reconciling Modern Doctrines of Deference with the Judiciary's Structural Role*, 53 STAN. L. REV. 1, 63–68 (2000).

95. Of course if the court is too demanding, it creates an insuperable burden precisely because of the immeasurability (and incommensurability) of many regulatory benefits. See, e.g., Henry S. Richardson, *The Stupidity of the Cost-Benefit Standard*, 29 J. LEGAL STUD. 971 (2000). On the

plenty of costs and alternatives to demand that the agency think about, especially if the court wants to make a point about the substance of the rule. And as here, where it backed the SEC toward a corner it was avoiding, the court can expose assumptions that the agency is uncomfortable articulating, or which its sense-making habits accept too uncritically.

VI. REGULATION VIA ENFORCEMENT

The discussion thus far has largely been about SEC rulemaking. But those familiar with the SEC have long pointed out that rulemaking is a far less frequent tool for policy formulation than enforcement, and that the Commission has often preferred enforcement to rulemaking for strategic reasons.⁹⁶ Here, I want to fit enforcement into the accounts of SEC behavior thus far advanced.⁹⁷

As administrative law has long worried, enforcement actions bypass controls, such as notice, comment, and judicial review, designed to introduce deliberation and accountability. In the SEC, cases are developed on a bottom-up basis, with investigations initiated privately by the staff. Commission approval is only sought mid-stream when subpoena authority is sought and when formal enforcement is to be filed against the defendants. Moreover, those steps are pursued only at closed meetings of the SEC. Judicial review is possible in contested matters, but in the context of whether the facts state a violation of law, not in the context of cost-benefit analysis of the enforcement action. Well-known, too, is that the SEC has extremely broad and open-ended statutory provisions or rules to invoke, such as its antifraud rule, 10b-5, which can readily mask subtle policy choices.⁹⁸ Among many examples of this, the SEC created the law

challenges of including *affective* costs and benefits, which includes a discussion of the mutual fund rules, see Huang, *supra* note 37, at 3–4.

96. For a criticism, see ROBERTA KARAMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 317–22 (1982). A useful study of SEC enforcement practices from an institutional perspective is SUSAN SHAPIRO, WAYWARD CAPITALISTS: TARGETS OF THE SECURITIES AND EXCHANGE COMMISSION (1984). On better ways to enforce the SEC's rules, see Cristie L. Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757 (2005).

97. For elaboration on many of these enforcement-related themes, see Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience*, in INVESTOR PROTECTION IN EUROPE (Guido Ferrarini & Eddy Wymeersch eds., 2006). An excellent empirical study of SEC enforcement practices and their relationship to private securities litigation is James D. Cox & Randall S. Thomas, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737 (2003).

98. See authorities cited in *supra* note 3.

of insider trading out of incremental enforcement actions under Rule 10b-5, making a profound change in securities law without any external vetting.⁹⁹ The empirical question of whether insider trading regulation generates more benefits than costs did not emerge until the regulation was cemented into place by judicial doctrine.

As such, enforcement is a mechanism by which some external influence can be blunted. The substance of a case usually does not become public until the case is brought, and in the great majority of instances there is a simultaneous announcement that the defendant has settled, thereby eliminating any judicial review. The significance of the case may be ambiguous—it certainly poses a threat with respect to similar activity (which may not heretofore been seen as at risk)—but the particular case will have distinguishing features that make the threat hard to quantify. And if external reaction is critical enough, the SEC or its staff can send signals that those outside the agency have misread the proceeding, blunting the criticism in the near-term.

Enforcement is also a way of reaching out for public support that has a political dimension. The publicity value of cases can be strong. Insider trading is the best example, where the underlying factual stories (occasionally with well-known subjects) connect to enticing themes like greed, privilege, and deception that, when communicated effectively, make the SEC's actions harder to criticize no matter what their secondary effects. The routine of insider trading enforcement, at a steady rate of 40–50 cases per year, probably reflects the perception that these are the SEC's most reliable public relations tools.¹⁰⁰

This can have important political consequences in terms of other agendas. One of the most interesting episodes in the SEC's modern history occurred in the early 1980s, when President Reagan appointed John Shad as Chairman, and with him came a strong deregulatory agenda. Much revisionism did occur, albeit made somewhat more difficult by the fact that congressional Democrats (who still controlled the House, and had strong alliances with some senior SEC staff) pushed back forcefully.¹⁰¹ At this time, the SEC mounted perhaps its most famous insider trading campaign ever, netting Wall Street insiders such as Ivan Boesky, Dennis Levine, and Michael Milken in a burst of favorable publicity.¹⁰² Strategic or not, this gave cover to whatever else was going on at the SEC.

99. See Langevoort, *supra* note 42, at 1320–22.

100. *Id.* at 1328–29.

101. See KHADEMIAN, *supra* note 10, at 179–82.

102. See DAVID VISE & STEVE COLL, *EAGLE ON THE STREET* 329–52 (1991).

This episode also illustrates the tangles between external and internal accounts of agency motivation. Although publicly this was aggressive securities regulation tied closely to the most sacred symbols of investor protection, fighting greed by leveling the playing field between the privileged and the ordinary investor, the particular targets were all closely connected to the hostile takeover and junk bond financing movements of the 1980s that Wall Street may have found lucrative, but which provoked anger and resentment in the business community at large.

The internal dimension of regulation via enforcement necessarily invites consideration of career effects. Enforcement activity is controlled by a single division within the SEC. Staff attorneys within this division are encouraged to find and seek authority to bring cases. There has been considerable turnover in high enforcement positions,¹⁰³ with attractive career possibilities existing on exit. Similar to the account offered earlier with respect to rulemaking, the career value for an SEC enforcement official is not from pandering to potential target-employers, but from having a reputation for being quite aggressive.¹⁰⁴ That aggressiveness generates increased fear within the targeted community and hence greater opportunities for the defense bar (who are also well represented in the ABA and comparable groups). The most savvy SEC enforcers may well push quite hard, but still leave something on the table for opposing counsel to take credit for with his or her clients, remembering that the tables will soon enough be turned.

The fact that enforcement is not simply lawyer-dominated, but litigator-dominated, probably has cognitive effects as well.¹⁰⁵ The work of the enforcement division is mostly a detective effort. Advocacy occurs when the lawyers and their supervisors articulate the violation of the law. That naturally inclines the lawyers toward an expansive view of the law that is disconnected from cost-benefit analysis and leads to a more moralistic, “right versus wrong” judgmental style. Not surprisingly, many accounts identify the enforcement division as having the greatest zeal for the agency’s historic mission,¹⁰⁶ thus acting as a repository for “crusader stories” in the SEC’s internal mythology. And here again, we see a blurring of the lines between internal and external. No doubt crusader

103. See Khademian, *supra* note 28, at 521–22.

104. Cf. Edward L. Glaeser et al., *What Do Prosecutors Maximize? An Analysis of the Federalization of Drug Crimes*, 2 AM. L. & ECON. REV. 259, 262–66 (2000) (emphasizing career-based human capital strategies in making prosecutorial decisions).

105. See Jeffrey J. Rachlinski, *Rulemaking versus Adjudication: A Psychological Perspective*, 32 FLA. ST. L. REV. 529 (2005).

106. See, e.g., KARMEL, *supra* note 96.

stories have substantial value in terms of their ability to motivate and inspire attorneys who are underpaid compared to their peers, and have far inferior resources with which to work. But these attorneys also know that the legendary knights of so many crusades are now the elites of the securities enforcement defense bar, which may incline ambitious SEC lawyers to follow the same path.

In many ways, then, regulation via enforcement is regulation deriving more from advocacy skills than analytical ones, and the law that evolves shows it. Insider trading is an obvious example. While its motivations connect closely to historic values, insider trading doctrine itself is messy, incoherent, and result-oriented, as nearly every scholar on the subject has pointed out. A more recent example has to do with fines in settlements with public companies growing out of enforcement actions. In 2002, the SEC extracted from Xerox Corporation the then-largest fine for issuer fraud or misreporting, \$10 million.¹⁰⁷ Within a few years, and dramatically in the aftermath of Enron and Worldcom, fines skyrocketed, so that multi-hundred-million dollar fines became fairly commonplace.¹⁰⁸

These massive fines are paid, essentially, by the companies' shareholders, who are the victims of the wrongdoing. So why such large fines, then? A common argument is that is that such fines deter misconduct, which certainly is plausible. But the vicarious liability question is very difficult both theoretically and empirically, and we have no strong basis for assuming that the obvious threatened costs to shareholders do indeed translate into higher rates of compliance by insiders.¹⁰⁹ Again, we see an advocate's cognitive style at work. And alternative hypotheses are not hard to think up: the publicity value of such fines is immense—which certainly serves a political interest for the agency—and individual career interests within the Division of Enforcement are no doubt bolstered by association with the most salient cases. The rapid escalation in the fines was not surprising, whether because higher and higher numbers were necessary for fines to remain newsworthy, or because enforcement attorneys were competing for the resulting career attention.¹¹⁰

107. Press Release 2002-52, SEC, Xerox Settles SEC Enforcement Action Charging Company with Fraud (Apr. 11, 2002), available at www.sec.gov/news/press/2002-52.txt.

108. One the effect of this, see Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691.

109. See *id.*

110. As a result of concerns expressed by two of the Commissioners, the SEC instituted policy guidelines on seeking corporate penalties in early 2006. Press Release 2006-4, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties, (Jan. 4, 2006) available at

VII. CONCLUSION

My point in all of this is that the SEC operates in a complex political ecology, making law in response to a multitude of shifting incentives, both external and internal. Although I have presented various accounts as alternative explanations for why the SEC behaves as it does, my prediction is that each explanation that I have put forward has some purchase. External pressures from organized interests, staff career concerns and agency mythology all play some role in the making of securities law. How much of the total mix any particular influence plays varies with circumstance: whether the stock market is up or down, whether scandals are fresh in the public's mind, who the key players are both inside and outside the agency, whether the SEC institutionally feels angry or embarrassed, etc.

The ultimate empirical question here is whether this complexity leads to law that is good, poor, or somewhere in between. Again, the answer is likely to be "it depends." Empirical research can help in the analysis of certain regulations, although clean tests are often hard to come by. The bulk of the academic research amply supports the idea that *some* securities regulation is necessary and productive.¹¹¹ Additional layers of regulation probably have diminishing marginal returns, however, especially in economies that have developed a stable institutional infrastructure. It is at the margins that the cost-benefit questions become particularly hard.

It is reasonable to predict that, in light of the foregoing, on average SEC regulations at the margins are likely to be inefficient (i.e., generate more costs than benefits).¹¹² Lawyer domination, lack of sufficient interest in empirical research, agency costs, and judgmental heuristics and myths come together to make a potently pessimistic case that outcomes are likely to be biased systematically in the direction of over-regulation.

Yet there are also more optimistic possibilities. Investor, managerial, and industry interests meet constantly with SEC staff, formally and informally. They have ample incentive to counteract internal agency biases that might prove harmful, and plenty of clout to assure that they are

<http://www.sec.gov/news/press/2006-4.htm>.

111. See, e.g., Edward L. Glaeser et al., *Coase versus the Coasians*, 116 Q. J. ECON. 853 (2001). For a very thoughtful essay on the underlying approach to priorities and line-drawing in securities regulation, see Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L. REV. 781 (2001).

112. See, e.g., Choi & Prichard, *supra* note 59. For a critique of the SEC's national market system regulation along these lines, see Mark Klock, *The SEC's New Regulation ATS: Placing the Myth of Market Fragmentation Ahead of Economic Theory and Evidence*, 51 FLA. L. REV. 753 (1999).

listened to carefully. The career backgrounds and future interests of senior staff make it likely that these communications will be effective.

The clout of these external interests might, of course, simply take us toward a cynical capture story, but it need not do so. Insofar as these external interests accept the need for credible securities regulation, they will want to constrain the SEC at the margins, but not interfere with its basic capacity to operate cohesively on core regulatory matters. Those constraints will be just enough to prevent serious errors and keep the agency on task. To be sure, there may be some bias toward the interests of established market participants as opposed to those of innovators and new entrants, but even this is constrained to the extent that some other established group wants to support innovation (e.g., institutional investors' interest in more efficient trading venues).

This account, which resembles John Coates' in important respects, seems to leave little place for SEC's internal cultural as a distinctive influence on regulatory outcomes. And I am persuaded that SEC culture does play an important role. But again, we can suggest a more hopeful story. If the role of organizational culture is to motivate by coordinating perceptions and conferring identity, a relatively strong culture is necessary for hard work to get done, especially in a bureaucracy not subject to serious competitive pressures. That securities regulation sometimes resembles religion more than science is not entirely such a bad thing, if it produces a higher rate of desirable regulatory activity than a disenchanted bureaucratic culture would. Giving the SEC the slack to create a distinctive identity as the "investor's champion" may be a reasonable price to pay for productivity, so long as the external constraints stay fairly potent as a reality check. This is an extension of principal-agent theory, which increasingly recognizes that leaving some room for agent autonomy may be optimal from the principal's perspective, even if it seems to leave room for unobservable defections from the principal's goals. Tighter control systems deliver worse outcomes.¹¹³

To be sure, bureaucratic slack may result in regulation that is of lower quality during those times when it expands (and external influences temporarily diminish) because the SEC is under threat or stress due to

113. For an interesting suggestion that some bureaucratic slack might produce better outcomes in terms of the responsiveness of agencies to congressional expressions of policy because of the psychological dynamics of negotiations, see Andrew Whitford et al., *Negotiated Compliance: Social Solutions to Agency Problems* (June 1, 2005) (working paper), available at www.ssrn.com/abstract=736271. Adam Pritchard offers a more pessimistic take on this: Wall Street by and large likes the outcomes of the SEC's pervasive biases and hence works to prevent the de-biasing that others might seek. See Choi & Pritchard, *supra* note 59, and accompanying text.

external scandals or trouble. Yet even this may have its benefits. It has a “tit for tat” character, creating an incentive for interested parties to avoid provoking the SEC by letting events happen that might put it under stress. And remember that the SEC’s culture is dedicated to a vision of investor protection; that is its history and mission.¹¹⁴ Managers, institutional investors, and the securities industry know that whatever direction the regulatory response takes, it is not likely to wander too far toward inclusion of other stakeholders’ interests or other political forces that, as both Coates and Roe emphasize, they fear during troubled times.¹¹⁵

Historically, there is ample evidence that the business community in the 1930s wanted an agency with a narrow investor protection mission rather than a broad public mandate. Whatever the actual political motivations behind this, the result is an agency that serves as a safety valve—responses to scandals and troubles are moved to a place (the SEC) where the things investors care most about, profitability and productivity, will not be forgotten. Even the culture, then, offers some constraint on SEC lawmaking. Moreover, although the culture’s inflated belief in disclosure efficacy might cause it to rely too heavily on disclosure some of the time, that same inflated belief might also act as a constraint on the scope of regulation; the SEC sticks to moderate disclosure strategies rather than considering more radical cures in times of stress.¹¹⁶

We might even find a kind word for lawyer domination. Common-law-style lawyers are more inclined toward case-by-case judgments than policies carved in stone, which means that regulation will tend to be more flexible as applied over time.¹¹⁷ As with Delaware corporation law, the resulting indeterminacy has some thermostatic virtue in terms of ease of adjusting to changed circumstances. And in a capital marketplace characterized by substantial uncertainty and rapid change, it may behoove lawyers to be skeptical about assuming we know more than we really do, and to prefer to pay close attention to the facts immediately available. None of these are unambiguous virtues, but the mindset could be adaptive in a setting where there are sufficient external constraints. The dialogue between SEC lawyer-regulators, who might be inclined toward caution, and external interests inclined toward competitive risk-taking might

114. See SELIGMAN, *supra* note 10, at 1–2.

115. See *supra* text accompanying notes 21–26.

116. Here, I repeat the question raised earlier: is the SEC’s historical culture weakening? To the extent that it is, and especially if broader public values like accountability are seeping in to compete with the traditional vision of investor protection, then these benefits (both political and motivational) are at risk of unraveling.

117. See KHADEMIAN, *supra* note 10, at 90.

actually produce good compromises in an uncertain world—especially if there is a desire to avoid large-scale failures that might be politically destabilizing.

I am not saying that any of these more positive perspectives is right. I am saying simply that we do not know enough to be too pessimistic or too optimistic. Perhaps the SEC errs systematically because of its own biases and its insufficient attention to financial economics. On the other hand, it is interesting how frequently economists find *ex post* that, notwithstanding the guesswork, the SEC's lawmaking predictions turn out reasonably well.¹¹⁸ The SEC might not be "expert" in the sense of acting rationally upon the available base of economic knowledge, but it might still be fairly functional at doing the job that Congress gave it: managing the uncertainty inherent in the task of securities regulation, promoting a reasonable degree of retail investor confidence, and cleaning up the worst abuses with only moderate misjudgments.

Of course, the right question always to ask is—compared to what? If one has a high degree of confidence in market solutions absent regulation, the current limitations on SEC slack are hardly good enough. My paper is not meant to assess institutional alternatives or possible correctives (e.g., enhanced judicial review of cost-benefit analysis, more insistence on developing empirical evidence,¹¹⁹ or making the SEC part of the executive branch¹²⁰), but only to suggest that the workings of the SEC are far more complicated than most of either its critics or enthusiasts portray, and that we need much deeper institutional study motivated by neither doubt nor enthusiasm.

118. See, e.g., Laura Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144 (2005); Allen Ferrell, *Measuring the Effects of Mandated Disclosure*, 1 BERKELEY BUS. L.J. 369 (2004); Merritt Fox et al., *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331 (2003); Prentice, *supra* note 7, at 816–32.

119. See Choi, *supra* note 59; Robert C. Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers, Too*, 22 GA. ST. L. REV. 251, 255 (2005) (calling both for greater empirical and cost-benefit work and also for sunset-type provisions so that regulation is re-assessed as its costs and benefits become clearer).

120. See Pritchard, *supra* note 8; cf. Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245 (2001).