A REJOINDER

*Jonathan R. Macey**

I. Introduction

In a rare moment of self-restraint, I resolved not to bother to write a comment to David Ratner's spirited but unconvincing reply to my earlier article in the *Cardozo Law Review*.[1] Since Ratner's response contained no *defense* whatsoever of the work of the Securities and Exchange Commission ("SEC"), no criticism whatsoever of my general theory of agency obsolescence, and no theory of its own to defend the SEC, it seemed to me at first that the best course of action was to allow Ratner's reply to serve as its own refutation.

But several things convinced me to craft this response. First, when my article was first written and published, the idea of actually eradicating a federal agency, as I suggested in the piece, seemed entirely farcical. Bill Clinton was riding herd over a Democratic Congress controlled by born-again regulatory zealots. But, although Ratner seems blissfully unaware, the zeitgeist has changed since the midterm elections in November 1994. Not only are the Republicans in control of the House and the Senate, but even Democrats are beginning to talk about "dismantling petrified central bureaucracies and returning power from Washington to states, communities and citizens."[2] Since, in my view, the SEC easily qualifies as a petrified central bureaucracy that is undermining the ability of citizens to engage in the critical pursuit of capital formation, I thought I would use this opportunity to celebrate this small glimmer of hope on the American political scene.

Another reason for crafting this brief rejoinder is because I think that the Ratner rejoinder implicitly raises two interesting issues of regulatory policy. And, because Ratner lacks the prescience to understand the implications of his own analysis, I thought that it would be a useful exercise to discuss the assumptions that are embedded in his rejoinder. The first issue concerns burdens of proof. As between Ratner and me, who should bear the burden of

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1 Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994).

2 Tom Brazaitis, *Democrats Counter GOP "Contract,"* PLAIN DEALER, Dec. 6, 1994, at 10A.

proof to demonstrate that the SEC is obsolete? Ratner, perhaps subconsciously, assumes that I bear the burden of proof, and that, because I have not proven that the SEC is obsolete (to his satisfaction anyway), then I have lost our debate. But, as I will discuss in more detail, I am not convinced that this assumption is correct.

A second assumption embedded in Ratner's analysis involves a causal linkage between the existence of the SEC and the fact that the United States has "the best securities markets in the world."[3] Like many apologists for the SEC, Ratner observes that the United States has both a large government bureaucracy that regulates the primary and secondary securities markets and excellent securities markets. And on the basis of these two data points he concludes that the former somehow has *caused* (or contributed to) the latter.[4] From an analytical perspective this is like saying that fire trucks must *cause* fires, because fire trucks appear on the scene whenever there is a fire. The reason we have an SEC is because the United States securities markets generate a lot of money. This pile of money attracts politicians and bureaucrats, who can attract political support and other benefits by regulating, or threatening to regulate, in this area.[5] Thus the securities markets are like the fire in my previous example. The SEC no more causes the securities markets in this country to be great than fire engines cause fires.

II. Macey's Lack of Self-Restraint

Of course, the real reason that I am writing this response is because the Ratner rejoinder is such an easy target. And I lack the self-restraint necessary to let readers determine for themselves how vacuous his arguments are. (I am not a particularly successful dieter, either.) But, after all, who could resist the opportunity to wonder why Professor Ratner, a self-styled apologist for the SEC, would care to point out that "[i]t may be that the SEC was already obsolete the day it was created."[6] Well, excuse me for bringing old news to the readers of the *Cardozo Law Review*! Regardless of when the SEC first became obsolete, if it is obsolete now, let's get rid of it.

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3 David L. Ratner, *The SEC at Sixty: A Reply to Professor Macey*, 16 Cardozo L. Rev. 1765, 1765 (1995).

4 *See id.* at 1779 ("The SEC is one important reason why the securities industry is in so much better shape than the other financial service industries.").

5 *See* Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. Legal Stud. 101 (1987); George J. Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. & Mgmt. Sci. 3 (1971).

6 Ratner, *supra* note 3, at 1766.

In a similarly self-revealing vein, Ratner repeats the old and hollow argument that the SEC is needed so long as there is fraud in the investment business. He notes that it is "[i]nteresting to see how many of the investment scams of recent years have been almost identical with the scams of fifty or sixty years ago."[7] That's right, David. And if the SEC still hasn't figured out how to put an end to these scams, why should we give them another sixty years? It's not exactly as though the agency operates at zero cost to the public.

Ratner goes on to assert that

> the SEC's function is not to make sure that information about issuers is disseminated quickly—that function is performed by the prompt disclosure rules of the stock exchange and the National Association of Securities Dealers ("NASD")—but to ensure that there is a body of reliable and consistent information available to enable the "market professionals" to make their analyses.[8]

But a mere two paragraphs later Ratner acknowledges that these market professionals were of no use "to the thousands of investors in bond funds who have suffered substantial losses because their 'sophisticated intermediaries' were speculating with highly leveraged derivative instruments."[9] Again, it would appear that Ratner is acknowledging that the SEC is failing to do the job he asserts that it was supposed to do. Isn't sixty years of failure long enough? It's simply impossible that a firm in the private sector that failed to offer a successful product over a sixty-year period could survive.

And the Ratner rejoinder contains that usual fundamental error committed by apologists for the SEC. Ratner asserts, without any support whatsoever, that mandatory disclosure is necessary to ensure that firms will issue reliable and consistent information about themselves. There are three flaws in this analysis. First, it ignores the fundamental fact that raising capital is costly. Investors demand to be compensated for the risks they bear in buying securities. Firms can reduce their capital costs by making disclosures. The antifraud rules serve as the mechanism by which the common law makes such disclosure credible: if the firm issuing the securities is lying, the remedy is a common-law action for fraud. The capital markets will punish firms that attempt to "hide" from analysis by

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7 *Id.*

8 *Id.* at 1767.

9 *Id.* at 1768.

declining to make disclosures by assuming the worst and imposing higher capital costs on such firms.

So much for mandatory disclosure of public offerings. As far as ongoing disclosure goes, it is difficult to credit the argument that the SEC plays a role that is even remotely similar to the role that Ratner has in mind. For one thing, firms are entitled to remain silent without fear of civil liability for making false and misleading statements.[10] It is only when they speak that they hold themselves open to the quixotic demands of the SEC and the plaintiffs' class action securities bar.[11] It is impossible to conclude that this bizarre system of incentives improves the quality, much less the quantity, of corporate disclosure of information.

Finally, the argument that the SEC is necessary to ensure that firms issue reliable and accurate information about themselves ignores the fact that the SEC's mandatory disclosure regime poses both costs as well as benefits to issuers and investors. For some firms the costs are simply higher than the benefits. And there is no reason to force these firms to undergo the costs of mandatory disclosure.

To illustrate the costs and benefits of mandatory disclosure, imagine three firms that want to sell securities to the public. One of these firms, called High Quality, Inc., is selling stock that is worth one hundred cents per share. Another, Medium Quality, Inc., is selling stock that is worth fifty cents per share, and the third, Dog Meat, Inc., is trying to peddle stock that is worth only a penny. Suppose further that we live in a "Ratnerian world" in which investors are entirely incapable of distinguishing, at the time they make their investments, the high quality firm from the low quality and medium quality firms absent disclosure. Suppose further that disclosure is not mandatory and that no firm voluntarily makes disclosure. Investors will pay fifty cents per share for a portfolio comprised of equal percentages of these three securities. Of course this will mean that High Quality, Inc. will be forced to sell its shares for fifty cents less than they are really worth, while Dog Meat, Inc. will be able to sell its shares for fifty cents more than they are worth. The result of this process is that Dog Meat will rush to market with additional shares, while High Quality, Inc. will withdraw its shares from the market. When investors adjust to this

10 Basic, Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5.").

11 *See* Junda Woo, *Judges Show Skepticism in Class-Action Securities Cases*, WALL ST. J., Jan. 11, 1995, at B8.

fact they will no longer be willing to pay even fifty cents for a portfolio of securities in this market, since the odds will be overwhelming that their portfolio will consist of more shares of Dog Meat, Inc. than of Medium Quality, Inc.[12] When this happens, in a Ratnerian world, even Medium Quality will withdraw its shares from the market, as the market implodes. But in the real world, high and medium quality firms will give the public quality assurances that they are buying high, or at least medium quality goods. In the absence of such assurance, investors will assume the worst.

The point of this simple exercise in the economics of disclosure is twofold. First, I wish to observe that it is the higher-quality firms that suffer from nondisclosure, and it is those firms that have the greatest incentive to voluntarily disclose information about themselves in order to permit investors to distinguish their firms from lesser investments. Second, and perhaps more importantly, it is worth noting that the firms of poor quality (the Dog Meats of the world) have little incentive to disclose. Investors will assume the worst about such firms if they do not make disclosures. Their assumptions will only be confirmed when such disclosures are made. Thus, the problem with mandatory disclosure is not that it drives high quality firms from the marketplace, but that it drives low quality firms from the market place. For example, if disclosure costs Dog Meat, Inc. more than a penny a share, the costs will be greater than the total return from the investment. Thus, the economic effects of mandatory disclosure are borne by these low-end (or, more accurately, high-risk) firms that are driven from the market because they must incur the high fixed costs of disclosure, without any of the concomitant benefits in the form of lower costs of capital.

Of course, as Ratner laboriously points out in his rejoinder, sometimes low-end firms will attempt to pass themselves off as high-end firms. But Ratner does not appear to understand that there is not a scintilla of evidence that mandatory disclosure prevents this any better than the common-law fraud rules that preceded the SEC.

12 George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

III. Burdens of Proof in Evaluating the SEC's Performance

This last point raises the issue of who should bear the burden of proof in evaluating whether an administrative agency has become obsolete or not. Interestingly, even Ratner appears to acknowledge at least the *possibility* that an administrative agency will become obsolete. He says that "[a]n agency, assuming it had a valid purpose when it was created, becomes obsolete when the problems that it was set up to deal with no longer exist, either because of technological changes, market changes, or other new developments."[13] Thus, Ratner believes that support for the SEC should continue as long as there are investment scams that separate investors from their money.

In my view, Ratner's position on the issue of agency obsolescence (despite the fact that he calls the concept of agency obsolescence "pretty simple") is outlandish. A comparison to the private sector illustrates the silliness of Ratner's point. The horse-and-buggy was introduced as a means to address people's transportation needs. But nobody would say that there continues to be a need for the horse-and-buggy because people continue to have transportation needs. Rather, the introduction of new inventions (such as automobiles and airplanes) has diminished, if not eradicated, the need for the horse-and-buggy, despite the fact that the general demand for transportation has increased dramatically.

In other words, the persistence of fraudulent practices in the marketplace is only a necessary but not a sufficient condition to justify the continued existence of the SEC. Contrary to Ratner's assertion, the continued existence of fraudulent practices is not sufficient to justify the continued existence of the SEC because of the possibility that the financial markets may have produced new mechanisms and technologies for coping with risk generally and with the risk of fraud in particular.

In fact, this was the basic point of my original article. New financial theories, such as portfolio theory, the efficient capital market hypothesis, and the capital asset pricing model all have emerged since the SEC was created. Since the SEC was formed, the Nobel Foundation has awarded the Nobel Prize in Economic Science to Merton Miller, Franco Modigliani, George Stigler, and James Tobin, among others. All these awards were, in large part, for the advances made by these economists in showing how inves-

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13 Ratner, *supra* note 3, at 1766.

tors could *eliminate* the very risk that the SEC was created to reduce. In a nutshell, financial theory teaches that investors can *eliminate* firm-specific risk—i.e., the risk associated with holding a particular security—by holding a diversified portfolio of securities. As Burton Malkiel has observed:

> [u]nsystematic risk is the variability in stock prices (and therefore, in returns from stocks) that results from factors peculiar to an individual company. . . . The whole point of portfolio theory is that, to the extent that stocks don't move in tandem all the time, variations in the returns from any one security will tend to be washed away or smoothed out by complementary variation in the returns from other securities. . . .
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> . . . The unsystematic part of the total risk is easily eliminated by adequate diversification.[14]

Thus, as I pointed out in the original article, modern financial theory, increased competition in the financial services industry, and new trading techniques and strategies for coping with risk indicate that the basic functions of the SEC are being performed—better and more cheaply—by the private sector.

But what about the argument that we still observe fraud in the securities markets? Isn't that alone a sufficient basis to justify the existence of the SEC? The issue is whether the activities of the SEC produce benefits that are sufficient to offset the direct and indirect costs of maintaining the SEC's regulatory system. These costs include, of course, not only the filing fees imposed on companies by the SEC, but also the prodigious costs of complying with the SEC's mandatory disclosure regime for firms that would not otherwise voluntarily make such disclosures, as well as the cost to firms of obtaining exemptions from registration.[15] At a minimum, the argument that the SEC imposes costs without concomitant benefits for investors or markets must be taken seriously. Indeed, even Ratner does not suggest that the SEC can be credited with having caused a reduction in the incidence of fraud in U.S. securities markets. There is certainly no evidence that there is less fraud in this market than in other securities markets around the world.

14 Burton G. Malkiel, A Random Walk Down Wall Street: Including a Life-Cycle Guide to Personal Investing 230-31 (5th ed. 1990).

15 These costs include not only fees for investment bankers, lawyers, and accountants, but also the additional borrowing costs borne by firms that are unable to make a public offering of securities because of the costs imposed by complying with the registration requirements of section 5 of the Securities Act of 1933.

More generally, I would argue that Ratner's comment reflects a general view that all social problems should be addressed by regulation: If there is fraud, the solution is to create an agency or pass a regulation. If there is a problem with long distance phone service (to use one of Ratner's examples), form an agency. His comment reflects not even a glimmer of recognition of the fact that regulation has not been particularly successful at solving economic or social problems. There is not even a glimmer of recognition of the fact that the countries that have tried to regulate the most have generally fared the worst. There is not even a glimmer of recognition of the fact that market forces have proven to be far more effective than government at generating information and producing meaningful economic change.

Ratner ignores the lessons of the economic theory of regulation, which teaches that politicians and regulators have poor incentives to act to further the broad interests of the general public, and very strong incentives to provide private benefits to well-organized special interests that are able to galvanize into interest groups to press for reform. Ratner assumes that the regulators, bureaucrats, and politicians who control the SEC are motivated by altruism, rather than by either political concerns or by the desire for personal or professional advancement.

Ratner's perspective on the ability of government (and the inability of markets) to solve problems leads him to his rather clumsy assumption that the mere existence of a problem justifies government intervention. He seems to assume that only markets, not governments, are imperfect. People doing cost-benefit analysis need not apply for positions in the Ratnerian world of regulatory nirvana.

IV. The United States and the Greatest Securities Markets in the World

Ratner is entirely correct to point out that the U.S. securities markets are the envy of the world. The United States boasts the broadest and deepest securities markets in the world. But is there any support for the proposition that the SEC deserves credit for this? The U.S. securities markets were quite robust before the creation of the SEC, so the best that can be said is that the SEC did not retard the development of those markets. More importantly, a variety of U.S. laws, from the Glass-Steagall Act which prohibits commercial banks from directly competing with securities firms, to the Bank Holding Company Act, which imposes severe activities restrictions on banks and, until this year, prohibited branch banking entirely, artificially kept U.S. banks weak relative to banks in other countries. This, in turn, forced U.S. companies to turn to the capital markets rather than to banks for their funding needs. It is this phenomenon, far more than anything that the SEC has done, that has caused U.S. securities markets to appear so impressive alongside their European counterparts. But U.S. pride in the strength of its capital markets must be tempered by recognition of the truncated nature of U.S. banking markets, which are quite weak by international standards. Indeed, there is only one U.S. bank among the top twenty banks in the world.[16] And there are more U.S. banks with offices in London than in New York. If the SEC is to receive credit for the strength of U.S. securities markets, shouldn't it also receive the blame for the weakness of the U.S. commercial banking industry?

Along these lines, Ratner makes the strange assertion that the SEC's insistence that foreign issuers must meet U.S. accounting standards has not hurt the development of U.S. equity markets.[17] The fact is that the New York Stock Exchange has lost considerable business to London as a result of the SEC's baseless accounting requirements. Ratner concedes that German companies have declined to list in New York because of SEC rules. And, after all, Germany is by far the largest economy in Europe, and one of the top three economies in the world. Moreover, in recent years substantial trading volume has migrated from the stock exchanges in Milan and Stockholm to London. This business might well have gone to New York if the SEC would recognize the simple fact that investors will adjust the prices they are willing to pay for securities in order to make up for any perceived deficiencies in disclosure.

Ratner credits the SEC with fostering competition in the securities market. This is simply not the case. Studies of the investment banking industry show that the industry is quite concentrated. And the cartelization appears in precisely those areas which fall under the SEC's regulatory authority. For example, the five largest underwriters of domestic corporate debt account for almost seventy percent of the market, and the five largest un-

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16 *The World's 100 Largest Banks*, INSTITUTIONAL INVESTOR, Aug. 1994, at 50 (New York based Citicorp ranked ninth in total capital).

17 Ratner, *supra* note 3, at 1778.

derwriters of public stock issues account for almost half of the market.[18]

Consistent with the interest-group theory of regulation, it appears clear that the SEC is acting to cartelize the industry. Its regulatory activities require firms to assume fixed costs which impose disproportionate burdens both on newer and smaller firms, and on rapidly growing firms, whose back-office operations may be slow to catch up with the growth of their sales and trading operations. The SEC's persistent concerns with "boiler room" operations have the effect of stifling new entry into the securities markets.[19]

V. Conclusion

In his conclusion, Ratner opines that the problem with my Article, "as with much of the law review literature these days, is that it proceeds from theoretical models, rather than from an examination of the real world and a balancing of practical alternatives."[20] In fact, my Article begins with a theoretical model merely to demonstrate a point that Ratner himself concedes, namely that it is at least conceivable that an administrative agency can become obsolete, and to develop criteria (which Ratner does not challenge) by which we might determine when an agency has become obsolete. From there I go on to discuss a number of specific examples from the real world, including SEC Rule 19c-4, the executive compensation issue, the history of the SEC's turf wars with other agencies, the SEC's position on loan participations, proxy reform, and the penny stock market. Indeed, Ratner confines himself in his rejoinder to a discussion of the specific issues that I catalogued in my original piece. His accusation that I do not discuss the real world is simply false.

More to the point, at the time my piece was published, Ratner probably was correct to point out that my Article failed to balance practical alternatives. This assertion seemed correct because the alternatives I was proposing (abolishing the SEC) hardly seemed like a practical possibility in January 1994. But what is practical should not be confused with what is desirable from a policy perspective. Moreover, things that seemed impractical in January of

[18] Alan Greenspan, Statement Before the Senate Committee of Banking, Housing, and Urban Affairs (Dec. 1, 1987), *reprinted in* 74 Fed. Reserve Bull. 91, 92-93 (1988).

[19] *See* Diana B. Henriques, *SEC Wins Big Round Against Stratton Oakmont Firm*, N.Y. Times, Jan. 12, 1995, at D2.

[20] Ratner, *supra* note 3, at 1778.

1994, seem a bit more possible in January of 1995. And who knows what the political landscape will look like in 1996.