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Ambivalent Reflections on Regulation

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"Ambivalent Reflections on Regulation"

By Roberta S. Karmel*

I want to begin this discussion with some personal and political observations. When I was in college, I considered myself a liberal. Accordingly, I was anti-business, pro-labor and in favor of government intervention in the economy, if not outright nationalization of essential industries for the public good. Of course, I was also all for civil liberties and civil rights, and I perceived no conflict between the goal of government control of business and the goal of freedom for individuals from government control.

No doubt my political views were influenced by my inability to picture myself as a union-worker, a member oc management or a government employee. Life after college was a blank. As it turned out, I filled in the blank post-college space in my life by making the decision each of you have made and going to law school.

In law school, my vague belief in civil liberties began to assume the form of legal principles. I grappled with the concepts of due process and federal jurisdiction. I visited a local women's house of detention with my criminal law class and my notion of criminal justice became less philosophical and more rooted in the treatment by government of people like me.

I was at that time inspired by the idea of John F. Kennedy's New Frontier, and I was prepared to give my support to a man who asked the American people to choose the public interest over private comfort. Although I still had trouble picturing myself as part of either the business or government establishments, the working world began to come into clearer focus. Upon graduation I became a government lawyer. I chose public service because it better comported with my idealistic notions about the legal pro-

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fessions than did private practice. There were also better opportunities for women in a government agency than in a law firm. The agency I chose was the Securities and Exchange Commission ("SEC"), which is an independent regulatory agency of the federal government, charged with investor protection and the promotion of fair and equitable trading markets.

As a prosecutor of securities fraud cases, I believed I was vindicating the public interest. When I went to court representing my client, the U.S. Government, I took it for granted that truth and justice were on my side. I was, in fact, one small cog in our federal system of criminal justice. My daily contact with that system transformed it, in my mind's eye, from a neo-classic temple where god like creatures dispensed justice to a dingy government building where faceless bureaucrats coped as well as they could with a faceless horde of miscreants.

I had frequent contact with white collar criminals. Some of them struck me as decent and engaging. And I also had frequent contact with defrauded investors. Some of them struck me as victims of their own greed as much as the greed of those who had defrauded them. I also spoke with men who were under indictment or even in jail as the result of my efforts. These contacts, and their combination, began to give me nagging doubts about the value of my work to society in general. I sometimes had trouble reconciling the cases on which I was working with such grandiose concepts as vindication of the law or the vitality of the capital markets.

I gave little consideration to what I might do next in life. It rarely occurred to me that later I might become a corporate and securities lawyer for a law firm, and represent large public corporations and regulated businesses in the securities industry. I could imagine myself teaching law students, but a law school professor seemed an occupation for someone older and wiser — a real grown up. It certainly never occured to me that I might one day be a Commissioner at the SEC.

The events of my life and in the political arena, however, were fast moving and unexpected. Less than 10 years after I left the SEC staff I returned as one of the commissioners heading the agency. I was a public figure, a Carter appointee. My ambivalence about government power had only been exacerbated by my personal experiences as a private practitioner, and by the history of the Nixon Administration. It is this ambivalance in particular that I want to discuss. I believe that Americans, and particularly liberals, are undergoing a profound rethinking of how to resolve the tension between the need to use government power for the

general welfare and the need to curtail that power, both because of economic and political concerns, and the fear of abuse of undue power. This rethinking is having a particularly significant impact on regulatory agencies like the SEC.

Before I launch more deeply into this subject, I think it would be instructive for me to explain what the SEC does and how it is organized. The SEC was created in 1934 as an independent federal regulatory agency.[1] It is a collegial body composed of 5 commissioners, with staggered 5 year terms, one of whom is designated Chairman. The majority of the Commissioners are of the President's political party.

The work of the SEC is investigative, prosecutorial, legislative and adjudicatory. The agency's work is conducted to a large extent by the staff of its operating divisions and offices. However, all official Commission action must be approved by a vote of the members of the Commission.

There are a number of different statutes which comprise the federal securities laws which the Commission administers.[2] But the greatest part of the work is concerned with the Securities Act of 1933[3] and the Securities Exchange Act of 1934.[4]

The 1933 Act generally requires that corporations file registration statements with the SEC covering offerings of their securities to the public. Such statements include information about the business and affairs of the issuer, including certified financial statements. The 1934 Act imposes continuous disclosure requirements on public companies and in addition, regulates the trading of securities in the public securities markets.

The Securities Act of 1933 and the Securities Exchange Act of 1934 are products of the Great Depression. They were enacted at a time when the stock market and the national economy were at their lowest ebb. The federal securities laws are premised on the theory that when a corporation seeks funds from the public it

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[1] Securities Exchange Act of 1934, ch. 404, §4, 48 Stat. 885 (1934) (current versions at 15 U.S.C. § 78d (1976)).

[2] Securities Act of 1933, ch. 38, §§1-26, 48 Stat. 74 (1933); Securities Exchange Act of 1934, ch. 404, §§ 1-34, 48 Stat. 885 (1934); Public Utility Holding Company Act of 1935, ch. 687, §§ 1-33, 49 Stat. 803 (1935); Trust Indenture Act of 1939, ch. 411, §§ 301-328, 53 Stat. 1149 (1939); Investment Company Act of 1940, ch. 686, §§ 1-53, 54 Stat. 789 (1940); Investment Advisers Act of 1940, ch. 686, §§ 201-221, 54 Stat. 847 (1940); Foreign Corrupt Practices Act of 1977, Pub.L. 95-213, 91 Stat. 1494 (1977).

[3] Ch. 38, §§ 1-26, 48 Stat. 74 (1933) (current version at 15 U.S.C. §§ 77a-bbbb (1976)).

[4] Ch. 404, §§1-34, 48 Stat. 885 (1934) (current version at 15 U.S.C. §§ 78a-kk (1976)).

becomes a public body and its managers and bankers become public functionaries. Legal protections are given to investors and shareholders as an incentive to buy securities.

At the time the federal securities laws were passed there was considerable debate as to whether they should compel full disclosure or whether the SEC should be given authority to regulate the business of public corporations. Although Franklin D. Roosevelt and the Congress which enacted the 1933 and 1934 Acts opted for publicity and information as the best federal policy for protecting investors, the debate between advocates of disclosure, like Felix Frankfurter,[5] and advocates of regulation, like William O. Douglas,[6] continues to the present time.

President Roosevelt's message to Congress recommending the passage of the 1933 Act emphasized that the purpose of the legislation was "to protect the public with the least possible interference to honest business."[7] There were many who doubted the value of the free enterprise system and who would have established governmental control not only of the manner in which securities could be issued but also of the very right of any enterprise to tap the capital market. President Roosevelt and the Congress, however, rejected demands for such direct federal regulation of public corporations.

In general, the securities laws do not federalize state corporation law, and the SEC has not attempted to regulate corporate conduct as such. Further, the Commission traditionally has relied upon such regulatory techniques as disclosure, competition and self-regulation, rather than the more common techniques of licensing, rate-making and standard setting. I believe that part of the SEC's reputation as an outstanding agency has been due to its limited regulatory mandate.

Nevertheless, in recent years there has been a clamor reminiscent of the 1930's urging that the federal government in general,

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[5] *See* L. BAKER, FELIX FRANKFURTER 159 (1969). Felix Frankfurter "defended the [Securities Act] publicly in the August, 1933, *Fortune:* '. . . The Securities Act . . . proceeds on the principle that when a corporation seeks funds from the public, it becomes in every true sense a public corporation. Its affairs cease to be the private prerequisite of its bankers and managers' . . ."

[6] *Id.* at 160. In 1933 William O. Douglas, then a professor of law at Yale, felt that the Securities Act of 1933 did not go far enough. He argued that it was of secondary importance in a program of social control over finance, and that merely to tell the truth "did not offer enough protection against skullduggery." *Id.*

[7] Message from President Franklin D. Roosevelt to the Senate (March 29, 1933), 73 CONG. REC. 937 (1933); Message from President Franklin D. Roosevelt to the House (March 29, 1933), *id.* at 954.

and the SEC in particular, exercise greater direct control over corporate conduct. Beginning in 1973, as a result of the work of the Offfice of the Watergate Special Prosecutor, the SEC became aware of a pattern of conduct involving the use of corporate funds for illegal domestic political contributions. Subsequent Commission investigations revealed that instances of undisclosed questionable or illegal corporate payments—both domestic and foreign—were widespread, and over 400 public companies made confessions of such payments to the Commission.

As a result of these disclosures, the Foreign Corrupt Practices Act[8] was passed in December 1977. This statute is an amendment to the securities laws and requires public corporations to make and keep accurate books and records and to devise and maintain a system of internal accounting controls. The SEC thus has a new potential for directly regulating the internal workings of corporations. How the Commission will implement its powers under this new statute remains to be seen.

Some critics believe that the SEC should be given much more regulatory power over corporations. Last year the Commission held public hearings on the subject of shareholder communications, shareholder participation in the corporate electoral process and corporate governance.[9] One of the witnesses in those hearings was Ralph Nader, who characterized the disclosures of questionable or illegal payments made by corporations to the SEC as a "corporate crime epidemic"[10] and advocated as an antidote a federal chartering statute for giant corporations. Other witnesses, including professor William Cary and Senator Howard M. Metzenbaum, rejected the idea of federal chartering, but argued for remedial legislation in the form of a minimum standards act. The premise of such proposed legislation is that the government should harness corporate power for the benefit of the general public. The thrust of such legislation would therefore be much broader than the SEC's traditional concern for investors and shareholders.

At the same time as some political groups are urging greater federal control of corporate conduct, others are urging a lessening of federal intervention under the banner of deregulation. Al-

[8] Pub.L. 95-213, 91 Stat. 1494 (1977) (enacting §§ 78dd-1 and 78dd-2 and amending §§ 78m(b) and 78ff of 15 U.S.C.).

[9] *See* Securities Exchange Act Release No. 15384 (Dec. 6, 1978).

[10] Statement of Ralph Nader, Official Transcript of Proceedings before the Securities and Exchange Commission In the Matter of Public Hearings on Shareholder Communications, Shareholder Participation in Corporate Electoral Process and Corporate Governance, File No. S7-693, page 205, September 30, 1977.

though the idea of deregulation is not new, regulatory reform has become one of the slogans of the Carter administration.

I believe that the appeal of deregulation is related to the changing public perception of government's role in our society. As professor Geoffery Hazard of the Yale Law School notes:

> We are in an age of diminshed reform expectations and greater skepticism about the uses of government intervention.[11]

The Carter presidency, unlike prior Democratic administrations of my lifetime, has not adopted a utopia-invoking slogan — such as New Deal, Fair Deal, New Frontier, or Great Society. Indeed, President Carter's recent State of the Union message suggested that America seek a "New Foundation" where the limitations of government would be recognized.[12]

The reasons for changing public attitude concerning governmental regulation are varied and complex. The economic and social policies of the New Deal which dominated the government for four decades were to some extent based on the psychology of the Great Depression. Expectations last raised in the call for a Great Society of the 1960's were left unsatisfied to create a legacy of disappointed idealism. The failure of these social programs, despite the money, efforts and energies invested, led to a skepticism about the government's ability to achieve even popularly acclaimed goals. The financial collapse of New York City raised serious questions about how economic and social programs can be financed.

Although we are in a period of economic difficulty, the axioms of the Great Depression do not necessarily provide solutions for these inflationary times. The Depression was perceived as socially unjust because there was such widespread poverty and unemployment in a land of unlimited opportunity. In Roosevelt's era, the cause of the economic crisis was perceived to be business, and government regulation was seen as a way to readjust unfair distributions of wealth.

In contrast, today the problem is inflation, which is also perceived as socially unjust because the incomes, goods and services of a limited economy are not being fairly distributed. But government regulation is considered part of the problem rather than an obvious solution. As the Commission's Chairman, Harold M. Williams, recently analyzed:

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[11] Falk, *A Suit Over the Loss of Private Pension Benefits Is One Issue Before Supreme Court in New Term,* Wall St. J., Sept. 28, 1978, at 48, col 1.

[12] *Text of the President's State of the Union Address to a Joint Session of Congress,* N.Y.Times, Jan. 24, 1978, at A13, col. 1.

> Inflation — widely characterized as our most pressing problem — is primarily a political phenomenon. At bottom, its cause is the failure of our political system to contain the growth of social demands within limits tolerable to the market.[13]

Another reason why many liberals are questioning the value of government regulation is that we witnessed such serious abuses of government power before and during the Watergate era. The conflict between the ideals of the welfare state and individual liberties becomes more apparent.

Much regulatory legislation is intended to provide the public, and especially consumers, with protection against perceived ills. I believe that we must begin to reassess not only the efficacy of that protection, but also whether the economic, legal and social burdens of maintaining this legislative insurance are worth such protection. All regulation is costly, not only because it is paid for by taxation, but also because it interferes with market forces, increases the size and complexity of government, and favors one group of people in our society over another. In many instances the favored group needs special consideration or protection. But often, the claims of the protected are no better that the claims of the regulated. Furthermore, the protected and the regulated may turn out to have a certain mutuality of identity so that the primary beneficiaries of a regulatory scheme are the regulators.

This means that even an acceptance of the theory that regulation is a major contributor to inflation will not necessarily result in any dismantling of the regulatory apparatus. The federal bureaucracy itself is a powerful special interest group because it depends upon and benefits many other influential interests. Every federal regulatory system has a political constituency.

One example which illustrates what I have been discussing is the Foreign Corrupt Practices Act.[14] Although Congress passed that statute in specific response to the problem of the bribery of foreign officials by American companies operating abroad, it vastly increased the S.E.C.'s regulatory powers over the internal accounting affairs of public corporations. If the end result of that statute is greatly to improve the record keeping and accounting controls of American corporations for the ultimate benefit of the general economy, the legislation will be all to the good. If, however, implementation of the statute primarily benefits govenment regulators and the accounting profession by giving them more

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[13] Address by Harold M. Williams at the Columbia University/McGraw-Hill Lectures in Business and Society, New York, N.Y. (Sept. 26, 1978).

[14] Foreign Corrupt Practices Act of 1977 Pub. L. 95-213, 91 Stat. 1494 (1977).

work to do without at the same time serving the larger public interest, this legislation may not prove worthwhile.

At the present time I am a public official — a federal regulator. By profession, however I am an atttorney, and I have devoted most of my career to the practice of securities law, a specialty which would not exist without the SEC. A recent commission of the American Bar Association, notes the role of the legal profession in the regulatory process as followws:

> Lawyers have been major participants in the development and operation of our present system of government regulation. . . . The legal profession thus shares responsibility for the better functioning of the regulatory system. This is especially true in the face of strong indications that the regulatory apparatus is not working well but is continuing to expand.[15]

As a lawyer, I am deeply distressed about what sometimes looks like an alliance between the regulatory agencies and the regulated industries for the benefit of the legal profession instead of the public. I do not believe this alliance is the result of malevolence or conspiracy. Rather, it is an unfortunate fall out of too much government regulation by an overly legalistic society.

As lawyers and law students I hope that you are likewise concerned about the regulatory process and that you will be active participants in the political process which will determine whether our independent regulatory agencies will become more or less powerful in the future. I have discussed my own ambivalence about the regulatory process, as well as what I perceive as countervailing political forces at work today with respect to regulation. At least one commentator, Professor James O. Freedman, has suggested that American ambivalence toward the independent regulatory agencies is endemic because they have been unable to persuade the public of their authentic governmental character.[16]

Professor Freedman theorizes that one reason for this failure of legitimacy is the great reverence Americans have for the doctrine of separation of powers.[17] The combination of powers in administrative agencies is therefore suspect. Further, Americans have failed to develop or agree upon a coherent philosophy of governmental activism in economic matters. He states:

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[15] ABA COMM. ON LAW AND THE ECONOMY, *Federal Regulation: Roads to Reform* 10-11 (Exposure Draft, Aug. 5, 1978).

[16] Freedman, *Crisis and Legitimacy in the Administrative Process*, 27 STAN. L. REV. 1041, 1045 (1975).

[17] *Id.* at 1046.

> The nearest approach our society has made to achieving such a philosophy has been to secure general agreement for the proposition that the appropriate extent of governmental activism in planning and controlling the economy lies somewhere between the polarities defined by Adam Smith and Karl Marx. . . .
> Administrative agencies, as the symbols of our belief that some degree of governmental regulation of the economy is necessary and appropriate, inevitably become a focal point in that debate. The imprecision of the ideology that justifies the existence of administrative agencies reflects the basic ambivalence of our society toward the process of regulation.[18]

My own thinking is still evolving concerning the proper balance between government intervention in the economy and freedom from government interference. Too often, we think of ourselves as consumers in need of protection, rather than producers who are being subjected to regulation. As William O. Douglas, an early SEC Chairman, stated in a late opinion while he was a Supreme Court Justice:

> The bureaucracy of modern government is not only slow, lumbering and oppressive; it is omnipresent. It touches everyone's life at numerous points. It pries more and more into private affairs, breaking down the barriers that individuals erect to give them some insulation from the intrigues and harassments of modern life.[19]

I would heed these words in striking the proper balance between government power and administrative restraint.

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[18] *Id.* at 1053-54.

[19] Wyman v. James, 400 U.S. 309, 335 (1971) (Douglas, J., dissenting).