



1993

Expertise as Power: A Case Study of the Securities and Exchange Commission

Edmund W. Kitch

Follow this and additional works at: <http://digitalcommons.law.yale.edu/yjreg>



Part of the [Law Commons](#)

Recommended Citation

Edmund W. Kitch, *Expertise as Power: A Case Study of the Securities and Exchange Commission*, 10 *Yale J. on Reg.* (1993).
Available at: <http://digitalcommons.law.yale.edu/yjreg/vol10/iss2/9>

This Article is brought to you for free and open access by Yale Law School Legal Scholarship Repository. It has been accepted for inclusion in *Yale Journal on Regulation* by an authorized administrator of Yale Law School Legal Scholarship Repository. For more information, please contact julian.aiken@yale.edu.

BOOK REVIEW

Expertise as Power: A Case Study of the Securities and Exchange Commission

Edmund W. Kitch†

Reviewing The SEC and Capital Market Regulation: The Politics of Expertise by Anne M. Khademian††

Anne Khademian's book, *The SEC and Capital Market Regulation: The Politics of Expertise*, is a case study in the field of political science whose objective is to demonstrate that some bureaucratic groups—in this case, the SEC staff—are capable of effectively exercising political power because of the expertise they possess. The book succeeds in synthesizing a large amount of information about the history and structure of the Securities and Exchange Commission. It ultimately stumbles, however, because of unresolved ambiguities about the nature of the expertise which the SEC staff possesses.

There is a second book lurking within the first that has an audience outside political science: a non-specialist account of the history and activities of the Securities and Exchange Commission based upon the literature and extensive first hand interviews with SEC staff, SEC commissioners, and congressional staff by an author who is uncritical if not a little star struck by her subject. The advantage of this book over its predecessors is that it carries the story up through the Reagan Administration. The book includes a comprehensive and up-to-date bibliography of sources relating to the SEC useful to any student of the subject. This second book is more successful than the first, and it is in that role that the book should find its way onto the shelves of those who wish to have an overview of the field of securities regulation as it is conventionally understood.

The author's main argument is based on a simple story about the SEC. After early ambiguity about exactly what the SEC was to accomplish, the agency settled into a "disclosure and enforcement" vision of its mission. Disclosure means that the agency requires those subject to its regulation to disclose the truth about their activities. Enforcement means that if they fail to disclose the truth, the agency will, upon discovery of noncompliance, initiate legal

†Joseph M. Hartfield Professor of Law, the University of Virginia.

††Pittsburgh and London, University of Pittsburgh Press: 1992; 278 pages.

proceedings against the violator. This vision has been subjected to a frontal challenge three times: first, when members of Congress attempted to prod the agency to implement a "national market system"; second, when John Shad, the Chairman under the Reagan Administration, attempted to change the Commission into a promoter of the industry and make it more sensitive to economic ideas; and third, either when the Commission decided to implement a system of electronic disclosure or when Congress decided to challenge the Commission's implementation of electronic disclosure. All challenges have failed upon confronting the well established norm of disclosure and enforcement whose high priesthood is the Commission staff and practicing securities lawyers.

The organization of the book is straight-forward. The introductory chapter relates the importance of Khademian's study to the political science literature. The second chapter, "A Regulatory Framework", recounts the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934 and the early experience of their administration, which resulted in an early focus on disclosure and enforcement. The third chapter, "Expansion, Delineation and Institutionalization", describes how the disclosure and enforcement perspective has been defended in the administration of the acts. The fourth chapter, "Maintaining Disclosure-Enforcement", describes the network of intersecting interests and objectives that sustain the disclosure and enforcement vision. The fifth chapter, "A Decade of Activism", describes challenges to disclosure and enforcement in the 1970s. The sixth chapter, called "Breaking the Rules", describes the Commission under the Chairmanship of John Shad, appointed by President Reagan, and the efforts to change the SEC in the 1980s. The last two chapters essentially summarize the previous chapters.

A unique resource used in the book is over one hundred hours of interviews conducted by the author with the regulatory "players" in the Commission, Congress, and the industry. The identities of the interviewees are not disclosed because they were promised anonymity so that they would feel free to speak frankly. To further encourage candor, the author did not tape record the interviews. She reports that "many spoke openly and frankly."¹ No doubt the interviews helped the author prepare her intelligent and informed summary of the Commission's history and activities.² But they do not appear to have yielded any novel information. Their significance is difficult to judge because

1. Page 231.

2. I have noticed two minor errors. On page 25, discussing the law prior to the federal securities acts, she contends: "The quality of protection and the level of enforcement varied from one state to another, but even the most effective antifraud statutes did not regulate interstate trafficking in securities." Of course, this is not wholly accurate in light of the broad reaching federal mail fraud statute governing at that time. And on page 116 she states: "Without larger staffs to police the disclosure activities of corporations, for example, the agency requires the vigilance of lawyers to alert it to discrepancies." Although some on the SEC staff might wish it to be the case, and the SEC has taken positions that imply it should be the case, the reality is that the agency does not receive its information from lawyers whose clients do not conform to the regulation.

at no place in the book are the interviews as a whole summarized. Instead, snippets are quoted from time to time in support of the author's points. One strong theme that appears to have been made repeatedly in the interviews is that the SEC staff is wonderful.³

Aside from the personal interviews, Khademian's research draws mainly from existing literature and government documents. There is no effort to access previously unknown material or to offer new interpretations of the known material.

The methodology of the argument is avowedly qualitative not quantitative. No effort is made to plot degrees of expertise on a numeric scale and then to test whether there is a correlation between expertise so measured and some numeric scale of power. There are no numbers and no equations. This gives the book a human and accessible character, and is an appropriate and necessary approach to the subject matter. Some social scientists undoubtedly find the methodology unscientific. But the issue of the role of expertise is important, and should not be ignored because currently fashionable methodologies cannot be used to study it.

As the author recognizes, her argument faces the problem of separating bureaucratic behavior that endures because it is precisely what the members of Congress and the industry want from behavior that endures in spite of the wishes of members of Congress and the industry because it is defended by an

3. The following are examples of such snippets from the book: "From the beginning, it was blue-ribbon selection for staff and commissioners, and there was great dependence placed on the agency and reliance to help steer the country to better economic footing. . . . And I think that there are many people in the industry who feel more secure knowing that regulation is even-handed and fair." Page 127. "We are taken seriously because we have no axe to grind. Our work is more respected than, say, FERC. They are industry driven. When we send a bill [to Congress], from a technical standpoint, no one would suggest anything [about the SEC's motives]. We are a cleaner agency. I say cleaner; I mean less industry-dominated." Page 156. "There is a trusting about the SEC. . . . The SEC is not political, and there is excessive respect for the agency. And the fact that securities legislation is very complicated, and consequential; no one wants to screw up." Page 189. "If I were ever to write a book about the SEC I would call it the 'peculiar institution.' It really is. . . . It's amazingly well insulated from politics, even with the scandals of the Nixon administration. The moral of those incidents is you can't fix the SEC. . . . It has a high quality staff, and there are some people there who really have a sense of mission. The government would be better off if it could infuse that spirit elsewhere in the government." Page 206.

The author argues that one reason the staff is independent is that the staff lawyers do not regularly go to work for firms in the industry after leaving the Commission. Instead, they go to work for law firms who represent the firms in the industry. The possibility that the staff serves the interest of the law firms by creating additional legal work for them to perform (and for the staff to perform in their new employment) is not discussed. "To prove that they can do good work, these attorneys must demonstrate their legal expertise. This has enormous implications for the agency's regulatory approach . . . as well as for its relative independence from the interests that it regulates. Law firms will evaluate these staff members, as aspiring members of the securities bar, by their legal skills rather than by the impact of rules or decisions on particular interests. . . . [Quoting two interviewees:] 'When you go to the SEC you don't work for much, but when you go back [to the private sector] you can make a lot. At the SEC, it doesn't do you any good to curry favor with the defense contractors . . . People don't go to work for the industry, they go to work for law firms, not brokerage firms.'" Page 90.

expert bureaucracy. The author does not insist that there is a sharp distinction, creating ambiguity about the nature of the expertise whose effects she is examining.

Although the author attributes "expertise" to the staff, and credits that expertise with the power to affect political events, she does not analyze or define what that expertise might be.⁴ There are moments when she seems to analogize it to the expertise of an engineer, who might know, for instance, how to build a bridge that won't fall down. Drawing upon some of the more controversial explanations of the 1987 stock market crash, she suggests that some members of Congress are reluctant to challenge the SEC staff because interfering with their expertise might remove the staff's support from the market, causing it to crash.⁵ The image of the expert staff laboring daily to hold the market up in the face of the forces of decline is comical to contemplate. At other moments, expertise seems to result from the fact that the staff is in a strategic position in which it can use its preferred access to information and ability to interact with all the players to punish those who stand in its way. The SEC staff is, for instance, able to make use of the fact that any violation of the statute or regulations is criminal. Although the SEC itself does not have the power to initiate criminal prosecutions, it can always refer matters to the Department of Justice. Thus, every SEC investigation is potentially criminal in nature. The Commission and its staff have the same insulation from politicians as do criminal prosecutors. A congressperson, White House staff member, or even president who seeks to influence an SEC proceeding can always be accused of acting as an accessory after the fact.⁶ Most frequently, the author has a third idea of expertise in mind: that expertise is the implementation of the program that the relevant political actors desire. Disclosure-enforcement "satisfies the needs of diverse interests in the securities industry that are important to Congress, and it gives members of Congress noncontroversial solutions that are seen as good policy."⁷ This third concept of expertise, however, robs the author's hypothesis of much of its power: expertise becomes doing what the bureaucracy's masters want it to do.

The author treats the example of the SEC staff as a suitable example of bureaucracy in general, and never pauses to speculate whether the SEC's status as an independent regulatory agency outside the executive branch makes it a special case, as its founders intended it to be.

4. The similarity to the idea of deference to agency expertise in judicial review is obvious here.

5. An interviewee explains: "No one wants to be blamed for a catastrophe. Answers are not clear in this area, particularly in the modern financial world. The markets are delicate and there is a precarious balance. Certain moves could have unintended consequences, and no one wants to be blamed for that." Page 13. See also page 113.

6. See pages 16-19.

7. Page 118.

The author is agnostic about what SEC regulation ought to accomplish. She takes the view of a disinterested observer of the political process, simply reporting on the interplay of ideas and events. She describes “securities policy” as “technical and uncertain.”⁸ Nor does she consider the possibility that the SEC does not really do what it professes to do. She does not consider the possibility that what is most important about SEC disclosure regulation is that there are many things that the SEC does not require be disclosed. She does not consider the possibility that SEC as an enforcement agency is a paper tiger.⁹ Her principal evidence for the enforcement prowess of the SEC is the fact that it has investigated the rich and politically well-connected. That, however, may simply result from the fact that violators of the securities laws will often be rich, and that they seek political connections as protection. The penny stock scam artists do not seem to find it difficult to operate in violation of SEC regulation for years.

At one point, she explains the strength of the enforcement vision as follows:

Though the public may decide to pull out of the stock market for a number of reasons—for example, a recession, inflation, higher interest rates in the money markets—fear of fraud is often cited as a cause. If brokers can ‘churn’ an account—excessive trading of a customer’s account in order to generate commissions—without being caught; if mutual funds can charge a customer hidden fees and place prohibitive restrictions on an account; if someone can claim to be an investment advisor without credentials; if inside traders can profit at the expense of shareholders; and if fraudulent issues of stock can easily be peddled to the public, people will consider securities a risky investment and pull out. Therefore, a strong agency to police these activities is important to maintain investor confidence.¹⁰

What is striking about these statements is that there is a great deal of evidence that they are all true. Many churning cases are brought by the customers, not the SEC, and it is hard to believe that more than a small percentage of the victims are able to bring a lawsuit. Mutual funds do charge hidden fees. People can claim to be an investment advisor without credentials. Insiders do profit. And fraudulent issues of stock are peddled to the public.

8. Page 11.

9. The SEC is, of course, quite small. After one subtracts the clerical and administrative personnel, the number of personnel for serious enforcement work is quite limited, and located at only a few locations. Any truly serious matter must be referred out of the agency to the criminal investigative and prosecuting agencies.

10. Page 99.

Does the SEC enforce enough? Or is its real function to help the industry by working to create a false sense of security, to make the investing public believe that stocks are not in fact risky?

The episodes described in order to demonstrate that the SEC staff can use its expertise to prevail over politicians are too complicated and ambiguous to provide clear support for the author's hypothesis. In the early 1970's, Senator Harrison Williams pushed the SEC to assume the role of market designer, leading the creation of a single and integrated national market system. These initiatives led to legislation, which ultimately had little effect. This role would certainly have been a departure from the disclosure and enforcement vision of the SEC's role. On the other hand, the principal objection to giving the SEC this role is that it would have eliminated competition among different market institutions, and that the SEC has not had (and never claimed to have) expertise in market design. One interviewee shrewdly observes that the initiative was probably designed to enhance fund raising leverage for the senators.¹¹

The discussion of Chairman Shad's efforts to increase the influence of economic thinking at the SEC, which lead to an amusing confrontation with Congress in which the Congressional committees attempted to cut off funding from the wrong office, ignores the fact that the most important reform at the Shad SEC was the expansion of the exemptions from the 1933 Act, and that the move towards expanding the exemptions began with Congress, not the commission.¹²

The Commission's conflicts with Congress over the troubled implementation of a system of electronic filing and disclosure (called EDGAR for Electronic Data Gathering and Retrieval system) at the Commission involved the design of computer systems, a subject as to which the Commission has no claim of expertise. In any case, everyone agrees that an efficient and effective system of electronic filing and retrieval would further the objectives of the disclosure and enforcement vision.¹³

An understanding of the central intuition that motivates this book—that expertise is an asset that can be used to create significant political power—is not significantly advanced by this book. What the book does convey is an understanding of the issues confronting the SEC in recent years and the responses of both the Commission and the Congress to readers unfamiliar with the activities of the SEC.

11. Page 133.

12. I am referring here to when it enacted section 4(6), 15 U.S.C. § 77d(6), in 1979.

13. As sketched at length in Langevoort, *Information Technology and the Structure of Securities Regulation*, 80 Harvard 747 (1985).