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THE DELICATE BALANCE OF REGULATION AND COMPETITION

AN ADDRESS

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THE DELICATE BALANCE OF REGULATION AND COMPETITION

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For the first time in a quarter of a century, or perhaps a generation, the attitude of the American people towards their government is undergoing a profound, far-reaching change. Prior to 1933, the predominant attitude was that government should interfere with business relationships and activities in a minimal way - as Henry Fonda put it in his commentary on the times of Franklin D. Roosevelt, "the government didn't do much for you, but it didn't do much to you, either." Only when conduct rose to the level of an antitrust violation would the government step in, and then not through a plethora of regulatory demands, but by court action directed against the identified abuses. Beginning with 1933, the people began to expect of the government a much more active role and a greater involvement in the regulation of economic activity. The agency of which I am a Commissioner is one of the fruits of that change in public expectations and public attitudes, as were a number of other government agencies that exist to this day. The

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government was expected to ameliorate the hardships inflicted by market forces and economic misconduct with programs, and thus regulation, often of a picayune nature, became the order of the day.

Gradually it became taken for granted that the best way to deal with societal and economic problems was through new layers of regulation; this was the new concept of how government should adjust or alter relationships among citizens and their economic institutions. This relationship between government and citizens was, of course, hardened during the Second World War when everyone accepted the premise that in order to properly muster and use the resources of the nation, the government had to assert a virtual dictatorial power over the lives of citizens and the utilization of our resources. With the conclusion of the war, much of the attitude continued, notwithstanding intentions during the 50's, which were little realized in practice, to decentralize governmental functions and restore to the states many of the activities which had been preempted by the federal government.

This particular pattern of relationship between the people and the federal government probably reached its high point during the late 60's as programs proliferated in an effort to confront with all the financial and other resources of the federal government, the problems of poverty, ill health, crime and the other afflictions of modern industrial society. In assessing this

history let us not demean or denigrate the idealism out of which these programs were born. They had their origins in the concerns of overwhelming numbers of Americans who were moved by the irony of the richest nation in the history of the world having within its borders large pockets of abject poverty, avoidable disease, inferior housing, educational deprivations, class and racial strife, and unequal opportunities. In large measure these efforts to ameliorate these conditions had their origins in the noblest of American sentiments and traditions - concern with the downtrodden, adherence to the notions of equality expressed in the Declaration of Independence, the Constitution, and the Emancipation Proclamation.

Notwithstanding the nobility of the origins of this governmental concern, it is apparent to most commentators these days that this relationship, this mode of activity, this degree of involvement by the federal government with the economy and the people is no longer conceived as an unquestioned blessing. There are increasing evidences that the people are impatient with governmental controls over their lives, their activities, and the way they go about their business. We now realize anew that government programs cost money, that government expenditures may fuel inflation, and that inflation is a tax on everyone, but one which impacts most severely those

least able to afford it. We are in the painful process of relearning old truths. Economics has always been characterized as the "science of scarcity" - that is, the subject matter of economics is the manner in which society allocates goods and services not sufficient in supply to satisfy all the needs of the people. In recent years, we seem to have believed that, in John Kenneth Galbraith's words, we had achieved "the affluent society" and that scarcity was no longer the problem that once it had been. However, even he, as well as other distinguished economists like Albert T. Sommers of The Conference Board, has recognized that one of the principal fuels of inflation has been the rising expectations of people which, when unfulfilled by the private sector, the government is expected to satisfy. The costs of satisfying these expectations we now know are not negligible.

There is now abroad in the land, and I might add from my observation, increasingly so, a belief that government should retrench and retreat, reduce the quantity of regulation, demand more achievement for expenditures - in the military vernacular of a few years ago, "more bang for the buck" - and generally find ways of letting competitive forces substitute for regulatory ones. There is increasing recognition of the fact that regulation has many costs, including significant costs of compliance which are evidently borne by the consumer.

President Ford stated this very succinctly at a conference with regulatory agencies which he convoked at The White House on July 10, 1975. He said,

"I think it is quite obvious that I feel very deeply that we must seriously consider the costs to the American consumers of all government activities, and this, of course, includes regulatory agencies. Regulatory reform is a theme that arose repeatedly in the course of last fall's Economic Summit Meeting. It is a theme that is finding, as I travel around the country, growing public attention and support, both in popular and economic literature, in the Executive Branch, and in the Congress, and, I am pleased to note among the government regulators themselves."

Indicative of the extent to which this attitude has spread among the American people is the fact that, in a time of otherwise fierce partisanship, there is no partisan bickering or disagreement with these goals. The Democratic leadership of the Congress on the occasion of a meeting with the President on June 25 of this year said,

"...free competition is the most efficient economic disciplinarian of the marketplace, and those economic regulatory mechanisms which were the product of the needs and abuses of the late nineteenth and early twentieth centuries are in need of fundamental reevaluation and overhaul, and perhaps discarding...We are perhaps closest to common ground with the President in the shared judgment that much economic regulation has proved a poor substitute for competition...."

While the principal spokesmen for this new American attitude have been associated with the federal government, and while most of the attention has been focused on federal regulation, nonetheless, it seems to me that these demands of the American people must touch you as they touch me and my colleagues in the federal government. We are indeed a government - more accurately, governments - of the people and one of our geniuses is that all these governments are responsive to what the people want. As Mr. Dooley said, "No matter whether th' constitution follows th' flag or not, th' Supreme Court follows th' iliction returns." We respond not only to explicit expressions spoken through the ballot box, but we also respond to the desires of the people as we sense them in many, many ways. It seems to me as clear as if there had been a referendum on the subject that the American people want those of us who exercise authority in our society at every level to reexamine how we are exercising that authority, whether we need to exercise all that authority, what we can do to reduce the complexity and cumbersomeness of the regulatory schemes that we administer, how we can make our programs more cost-effective, the extent to which we can remove barriers to market competition and let competitive forces perform much of the role that in the past may have been supplied by regulation.

I say this applies to all of us. The Securities and Exchange Commission is an independent regulatory agency, meaning that its members are appointed for fixed terms, it is not a part of the executive, legislative or judicial branches of government, it is required to exercise its authority free of partisan consideration. While we are thus structurally independent, it seems to be that we can in no way regard ourselves as independent of the American people and we must reflect in our judgments what the American people are saying clearly they want their government to do.

The Commission on the occasion of the President's conference at The White House was singled out as an agency which had taken a significant step to replace regulation with competition - namely, we had eliminated fixed commissions on the nation's securities exchanges after almost two centuries of existence. I would like to claim this was a response to this newly-felt mood and desire of the American people, but the truth is the roots of this decision reach back to the mid- and late-1960's when the first serious questions concerning the fixed commission way of doing business were raised at the Commission and by other observers as well. Nonetheless, there is no question that this decision is in harmony with the mood of the times.

In other ways we are also trying to lighten the load of regulation on the activities of those whom we regulate. The content of advertising by investment companies has since 1950 been closely, even meticulously, regulated by the Securities and Exchange Commission through rules administered by the National Association of Securities Dealers. Many in that industry have complained that this mode of regulation has placed them at a competitive disadvantage with respect to other seeking the dollars of investors - savings and loans, banks, securities dealers, insurance companies, and the like. During the last 4 years, we have relaxed the rules with respect to advertising and have now permitted a number of practices which were previously forbidden. While I think this movement has been wholesome, I must say that I share with many members of that industry the conviction that perhaps this reform has not gone far enough and they still are unduly disadvantaged by the strictures on their advertising. I would not advocate a complete abrogation by any means of these restrictions, but it does seem to me that perhaps there is additional room within which we may let the forces of competition rather than those of regulation determine what meets the eyes of would-be investors and rely more on the common sense of the American people to keep them from frittering away their savings because of a pretty picture or a catchy phrase.

Habits are not easily broken. After a generation - and more for that matter - of expecting regulation to provide solutions to virtually every problem, it is difficult for us to fathom, and adapt to, the new expectations of the American people. I would like to discuss some of the courses which might be taken by you and by us, and some measures which already have been taken, which I think serve the end of simplifying government and reducing its burden.

First, I think it is imperative that every effort be made to eliminate duplication. An example of what already had been done through the fruitful cooperation of you and the Commission has been the development of the FOCUS Report which has eased the problem of broker-dealers reporting their financial conditions to multiple authorities immeasurably. On the same order has been the development of the uniform application form for broker-dealers, agents and others in the securities industry. Thus broker-dealers and others have been relieved of the necessity of mastering the intricacies and subtleties of innumerable forms. It is probably impossible to estimate the total savings in man-hours accomplished by this, but needless to say, it has been substantial. The extent to which we have reduced the incidence of profanity in the back-offices of broker-dealers is probably substantial, too.

It seems to me that the present ALI codification proposal for meshing state and federal regulation of securities offerings is another step in that direction. It marks out clearly the respective concerns of the states and the federal government and provides a means of avoiding overlapping and duplication of effort. It does not represent an effort to denigrate or diminish the importance of the respective states and their policies, but rather moves in the direction of simplifying government and avoiding needless duplication of effort and expense.

Second, we must be increasingly alert to the costs as well as the benefits of regulation. At The White House conference of which I spoke, the President singled out the need for heightened cost-benefit analysis by regulators as a part of any program to make regulation less costly and burdensome and more effective. This need has been echoed by others. Professor Murray L. Weidenbaum has said,

"...consideration of proposals - and they are numerous - to extend the scope of federal regulation should not be limited, as is usually the case, to a recital of the advantages of regulation. Rather the costs need to be considered also, both those which are tangible, and those which may be intangible...In earlier periods, when productivity and living standards were rising rapidly, the nation could more easily afford to applaud the benefits and ignore the costs of regulation. But now the acceleration of federal controls coincides with, and accentuates, a slowdown in productivity growth and in the improvement in real standards of living. Thus, the earlier attitude of tolerance toward controls is no longer economically defensible."

In much the same vein, Professor Paul McCracken, former Chairman of the Council of Economic Advisors, has said,

"The single most important source of economic waste comes from failure to identify and evaluate what is being given up when we go for something that itself is 'good'."

I think we all recognize that in many instances a cost-benefit equation is extraordinarily difficult to develop in a regulatory context. Sometimes we can get an imprecise handle on the cost of a regulatory proposal, although even that is slippery. Defining the benefit, however, is even more difficult.

How do you measure, for instance, the costs of a net capital rule rigidly enforced against the benefits to the public? How can you measure the value of the protection afforded the public by the registration and disclosure process against the very significant costs which follow from those rules, both the costs of complying with them and the costs of enforcing compliance? Crude estimates of costs can in many instances be made; the benefits are more elusive, even though many, like Professor George Stigler, have concluded they have been nil - a conclusion I hasten to add I do not by any means share. Notwithstanding these difficulties it does seem to me that if at least we try to think habitually in these terms, while an exact equation may escape us, nonetheless, we will add a dimension

to our thinking with respect to regulatory problems. On occasions at the Commission we have rejected proposals by the staff because of an apparent imbalance in this equation. We were in these cases not able to develop precise estimates of what the cost would be of the proposal if adopted or of the benefits which would follow. But nonetheless, taking into account all the information available to us, we felt that the expense would be significant, the benefit small.

Third, I think all of us must review our past patterns of regulation and determine the extent to which they have been obsoleted or perhaps have lost the reason for their being. An old friend and client of mine when I was in practice suggested to me when I came to the Commission that one of my objectives should be to establish a procedure at the Commission under which for every new rule adopted by the Commission, two would be taken off the books. While that may be a somewhat simplistic approach to the problem, nonetheless I think it is an expression of the spirit that should animate us in reviewing the efficacy and the utility of our efforts at regulation.

Fourth, we must recognize that accompanying impatience with overregulation has been a renewed faith in the forces of competition and a renewed conviction that a maximization of

competition in the marketplace whenever possible, without undue detriment or harm to the public, is the best assurance of a healthy, thriving economy. Central to the ideology of this country has been the conviction that markets in which the free forces of competition operate to the maximum extent possible will yield the greatest benefit to the people. By this means, the inefficient producers fall by the wayside, the most efficient produce at the lowest cost, thus making goods available to the public at the lowest price. We all know that, while a completely efficient marketplace is a commendable goal, there are inevitably imperfections and shortcomings in any market. For instance, one of the characteristics of a completely free market is ease of access and yet in many industries today, certainly industries such as steel, aluminum, and automobiles, entry requires a forbidding capital investment, with the result that necessarily the full flexibility of the marketplace is impeded. The danger that these imperfections of the marketplace might result in socially undesirable aggregations of economic power, and that some of the players in the marketplace might misuse their freedom to compete unfairly gave rise to our antitrust laws which have been an effort to put restraints upon such abuses and the consequences of such imperfections. In the eyes of many, the effort to remedy these imperfections and these abuses by regulation has swung the pendulum excessively

away from competition and they are urging that once again we recognize the strengths and validities of an economic system in which competition is sought to be maximized consistently with the protection of the people against abuses in the marketplace.

Congress, when it enacted the Securities Acts Amendments of 1975, made clear its conviction that whenever possible competition in the securities industry should be maximized. I doubt if any piece of legislation ever adopted by Congress contained the word "competition" as often as this one did. While recognizing the desirability of appropriate regulation, Congress nonetheless made it clear that such should be the course pursued only when it was apparent that competition could not adequately accomplish the goals sought in the legislation. Thus the Commission was mandated to use its powers to remove in every area of the securities industry impediments to competition, and in the exercise of its regulatory powers it was the command of the Congress they be used in the manner that would afford competition the maximum opportunity.

It seems to me that one of the greatest impediments to reliance on competitive forces in the marketplace is impatience and unwillingness to let competition take its course and a

hesitancy to accept the consequences of it. Inevitably there will be times when it appears that the market is misallocating resources. At those times the near-irresistible temptation of those with authority will be to intrude into the marketplace and seek a quick remedy of the distortion or misallocation. It is then that I think patience is demanded and a careful consideration of whether the harm that would follow from a regulatory intervention might be greater than the distortion itself. We are often reluctant to accept the fact that one essential aspect of competition is that the less efficient producers in a competitive market lose out. We are a compassionate nation; we sympathize deeply with those who are the victims of misfortune and seek to alleviate their plight. Out of this compassion has arisen in many instances a reluctance to accept the fact that failure is the correlative of success in a competitive economy and that the inevitable consequence of a free competitive market will be the elimination of those who cannot cut it in the marketplace. Sometimes it would appear that regulation is intended to protect the inefficient producers from the consequences of their own incapacity. When this happens, they may be the happy beneficiaries of the regulatory course, their more successful competitors will perhaps be even happier because their margins of profits will be swollen, but the ultimate losers will be the people who buy the products because prices inevitably will be higher.

Somewhat surprising is the sad fact that frequently those who proclaim most consistently their dedication to competition and free markets are the very ones who, when that freedom inflicts injury on them, suddenly turn strongly protectionist and seek the intervention of the government. Not infrequently it is suggested that in some fashion the government should intervene to hinder the growing success of one part of an industry or one entity in an industry or some activity in an industry. I spoke of being surprised by this and yet, I suppose one should not be: self-interest usually predominates over ideology in the long-run. It seems to me that a much more appropriate response of American business when a competitor achieves an innovative breakthrough is to develop the means of effectively competing, rather than seeking means of frustrating success in a negative and destructive way.

Finally, certainly one of the objectives which must be sought when we regulate is equivalence of regulation - simply put, those competitors similarly situated should be regulated in as nearly an equivalent a fashion as possible. It has been a frequent complaint in the securities industry that many of their activities are regulated more closely than the activities of competitors in other industries which are not subject to the securities industry regulators. As I mentioned earlier, investment

companies have often complained that they are subject to much greater strictures with regard to their advertising and promotional activities than other competitors who are seeking the same saver's dollars. Similarly, the New York Stock Exchange has often contended that its members are subject to a more restrictive system of regulation than competing dealers and brokers who are not members of the Exchange. To the extent that these charges are true it seems to me that there is a valid case for remedy. In some instances the problem is complicated by the fact that there is more than one regulating agency involved. For instance, the banks, which appear increasingly in roles and activities that are competitive with the securities industry, are regulated by various agencies, notably the Federal Reserve Board, the FDIC, the Comptroller of the Currency and state banking authorities. Not surprisingly the regulatory philosophies of these agencies may in many instances differ somewhat from that which characterizes the SEC in its regulation of the securities industry. The reconciliation of these conflicting philosophies, or perhaps more accurately, moderately inconsistent philosophies, and the achievement of an equality or at least equivalence of regulation are not easily done. There is much history in every agency and each derives its own particular

approach to problems from its considerable experience and a deep-seated belief in the effectiveness of its particular scheme. However, I think mechanisms can be developed to smoothe out whatever lumps there might be. An example of the manner in which this can be done is displayed by the portions of the Securities Acts Amendments of 1975 which established a system of regulation for brokers and dealers in municipal bonds. A single board was established consisting of representatives of the banking side of the municipal industry, the securities industry side, and the public to prescribe rules that would be equally applicable to all those engaged in the business. Investigatory and enforcement powers were given in the case of banks to bank regulatory authorities and in the case of the securities industry participants to the SEC. However, as a means of assuring some evenness of enforcement, the Commission was given, subject to an obligation to consult with the banking authorities, the power to proceed against not only securities industry participants, but banking industry members as well. The effectiveness of this particular structure is yet to be proven, of course, since we are only now in the process of establishing the municipal rulemaking board. However, I think it is a good example of the manner in which multiple regulatory agencies which have legitimate claims to primacy in the regulation of various competitors can be reconciled and accommodated.

Reducing the level of regulation does not in my estimation mean that we turn the ruthless, the unprincipled, the overreaching, the vultures loose on the people without restraint. It does not mean that we dismantle our enforcement machineries, or reduce the rigor of our efforts to see to it that our laws are observed, or lie supine in the face of an identified evil - and I certainly do not think this is what President Ford or others who have advocated a deemphasis of regulation have meant. As a matter of fact, the agency headed by the most enthusiastic advocate of decreased regulation, the Federal Trade Commission, only week before last, proposed extensive rules to outlaw a number of vicious practices in the undertaking business. The laws which your legislators and the Congress have adopted for the protection of investors are important statutes. They are important not only because they protect investors, but because, by protecting investors, they safeguard the capital formation process of this country, which, as we know, is in a state of crisis with doubts expressed as to whether we will be able to muster the capital which we need to satisfy the needs of the rest of this country. These are important laws, expressing the desires and needs of the people, which have been entrusted to us to enforce vigorously, forcefully, aggressively - and fairly.

What is needed is not less vigilance in protecting investors, but less haste in adopting the regulatory remedy, greater caution in assuming regulation's benefits, more sympathetic consideration of the fruits which may accrue from competition, an increased alertness to opportunities to let competition perform in place of regulation. If all of us in this regulation business pursue these paths, I am confident we will be responding to the deeply felt convictions of those all of us serve -- and those who in the final analysis employ us - and if we balance prudently the roles of competition and regulation, the public will continue to enjoy the protection we have all sought to give it.