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The Economics of Securities Regulation: A Survey

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ABSTRACT

This monograph reviews the academic literature that analyzes securities regulation from an economic perspective. It begins by describing the institutional foundations of securities law in the U.S. and distinguishing securities regulation from the private law of contracts, property, and fraud. Section 2 discusses the theoretical literature on mandatory versus voluntary disclosure in securities markets, focusing on information asymmetry and agency problems as justifications for mandatory disclosure. Section 3 surveys empirical work on the efficacy of actual mandatory disclosure rules. The remaining sections describe particular aspects of the U.S. regulatory system, including regulation of public offerings, publicly-traded companies, trading markets, securities fraud, insider trading, market manipulation, and mutual funds and other collective investment vehicles, and surveys important theoretical and empirical work on each. The monograph is intended to offer both institutional background and a summary of key research findings that may provide useful starting points for future research.

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1

Introduction

Securities markets are among the most heavily regulated sectors of the economy in developed nations. This monograph gives an overview of the U.S. regulatory system, explores the justifications for regulating securities markets, and describes the qualitative and quantitative literature that assesses the regulatory system's effectiveness. The monograph draws on, but does not attempt to summarize or evaluate, the literature on the role of information in securities markets. Although detailed examples of regulatory provisions will be drawn from the U.S. securities laws, many of them have close analogues in other countries.

The monograph will focus initially on mandatory disclosure, which is the most important feature of U.S. securities regulation. It will then provide brief reviews of other specific regulatory categories, including regulation of public offerings, publicly-traded companies, trading markets, securities fraud, insider trading, market manipulation, and mutual funds and other collective investment vehicles. It will consider throughout whether the regulatory system can outperform litigation under the ordinary rules of property, contract, agency, and fraud, taking the costs of each system into account.

1.1 Importance of the Topic

Securities regulation is an important topic for financial economists. Households use securities investments to save for retirement, schooling, and health care, among other things. The secular replacement of defined-benefit pension plans with defined-contribution plans has given ordinary savers a more direct stake in the health of the securities markets.

Regulations that make securities markets more or less efficient in channeling savings to businesses and the resulting returns from businesses to households have a direct and potentially substantial effect on welfare. In their role as designers and analyzers of government policies, economists pay particular attention to financial market regulation.

Descriptive study of the financial system also requires an awareness of the substance and effects of securities regulation. Regulation constrains the behavior of market participants. To understand how securities markets function, researchers must consider the constraints.

Securities regulation also offers a case study of the causes and effects of regulation generally. Economists' interest in regulation began with the problem of natural monopoly and the resulting price regulation of public utilities (Peltzman, 1993; Tirole, 2015). For centuries, however, governments have imposed restrictions on other markets with the stated purpose of correcting their excesses, or market failures. Why governments select particular industries for lighter or heavier regulation, why the scope and type of regulation in a given industry varies over time, whether regulation confers public benefits in excess of its costs, and whether and how it redistributes wealth are critical questions.

1.2 What is Regulation?

I begin by defining the term "regulation" for purposes of this monograph. A market-based economic system coexists with the legal institution of private property that can be exchanged by consent. Non-consensual interference with property rights, for example by theft or fraud, is a legal wrong. The victim may redress these wrongs, typically through litigation.

These legal building blocks regulate economic activity, but it is not useful to include them in an analysis of the efficacy of securities regulation. They are instead fundamental prerequisites to the existence of a securities market. Securities are intangible sets of rights defined by a contract or by a contract-like corporate charter. There are no securities without a functioning system of property and contract law. Conceptually, securities regulation consists of legal rules that supplement and sometimes supplant those that serve as the building blocks of a market economy.

The observation is pertinent because there is a common rhetorical strategy that describes the alternative to proposed regulations as a lawless "wild west" in which fraud would go unpunished and investors would have nothing but their wits to protect them. The rhetoric can bias policy analysis. An SEC economist has noted that "A common mistake in evaluating the net benefits of a regulation to society is to assume that a state of laissez-faire would arise in the absence of regulation" (Alexander and Lee, 2004). The "unregulated" market that forms the baseline for this paper is subject to generally applicable rules of property, contract, tort, agency, and criminal law enforced by general-purpose police, prosecutors, and courts.

Shavell (1984) draws a useful distinction between regulation and the background rules of private law in a discussion of product safety regulation:

> Tort liability is private in nature and works not by social command but rather indirectly, through the deterrent effect of damage actions that may be brought once harm occurs. Standards, prohibitions, and other forms of safety regulation, in contrast, are public in character and modify behavior in an immediate way through requirements that are imposed before, or at least independently of, the actual occurrence of harm.

This formulation incorporates two common features of securities regulation. First, regulation employs commands designed to prevent harm *ex ante* instead of, or in addition to, allowing a victim to pursue a remedy *ex post*. Second, securities regulation typically gives a government agency that is not part of the regular police, prosecutorial, or court systems the power to make and/or enforce these commands.

Economists have proposed other definitions that differ primarily in focus, not substance. Schwartzstein and Shleifer (2013) emphasize the distinction between *ex ante* screening by a government agent and *ex post* litigation. Hart (2009) observes that regulation often controls behavior through restrictions on output rather than on prices. In securities markets and other contractual settings, regulation therefore "restricts the feasible set of contracts available to the parties." Zingales (2009) distinguishes regulatory and market protections, implicitly including the operation of private legal rights within the "market" category.

Real-world systems for protecting investors generally include a mix of the background legal rules enforced by courts and *ex ante* regulation (Shleifer, 2005). This is likely so because each strategy has its own characteristic imperfections, creating space for a mix of policy tools (Djankov *et al.*, 2003).

A satisfactory justification for a regulatory provision should explain why the standard toolkit of the baseline legal system does not enable economic agents to solve the targeted problems. In those cases, the regulatory system provides alternative solutions from its own standard toolkit. I next summarize the latter as it exists in the United States.

1.3 The SEC and Its Powers

The Securities and Exchange Commission was created by the Securities Exchange Act of 1934 and administers that statute and others, including the Securities Act of 1933, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.[1] Subsequent major statutory reforms, such as the Securities Acts Amendments of 1964 and 1975, the Williams Act of 1968, the Sarbanes–Oxley Act of 2002, the Dodd–Frank Wall Street Reform and

[1]Prior to its repeal as part of the Energy Policy Act of 2005, the Public Utility Holding Company Act imposed substantive regulation of the corporate structure and financial transactions and policies of electric and gas utility systems and was primarily administered by the SEC.

Consumer Protection Act of 2010, and the Jumpstart Our Business Startups Act of 2012, generally amend one or more of the New Deal-era statutes, principally the Exchange Act. They may also include certain stand-alone provisions not codified as part of the statutes listed above.

The SEC's governing statutes give it the authority to make rules having the force of law within specified substantive limits. The legislature need not approve these rules but can change the relevant statute to override them. In limited circumstances, Congress may reject a regulation through the Congressional Review Act without amending the governing statute(s).

The SEC's governing statutes require that its rules be justified as necessary to protect investors and that the agency consider whether a proposed rule will promote efficiency, competition, and capital formation. Agencies such as the SEC adopt rules through a process set out in the Administrative Procedure Act (APA) that involves giving public notice of a proposed rule and providing interested parties an opportunity to comment on it. Affected parties may, and often do, challenge an agency rule in court on the grounds that the agency did not follow the APA or that the rule exceeds the agency's statutory authority.

The SEC is a so-called independent agency, in contrast to executive departments such as the Department of the Treasury or the Department of Labor. This means, among other things, that its five commissioners serve for fixed terms rather than at the President's pleasure. Independent agencies are not subject to the formal cost-benefit analysis requirements imposed on executive departments by statute and executive orders. The U.S. Court of Appeals for the District of Columbia Circuit, whose geographical jurisdiction often puts it in the position of considering the validity of federal agency rules, has nevertheless interpreted the statutory requirement that the SEC consider efficiency, competition and capital formation to require that the SEC assess the likely costs and benefits of proposed rules. Coates (2015) provides a detailed discussion of the legal requirements for cost-benefit analysis as applied to financial regulators.

Securities statutes also give certain registered entities, including securities exchanges, the Financial Industry Regulatory Authority (FINRA), and the Municipal Securities Rulemaking Board, among others, the status of "self-regulatory organizations" (SROs) that may make rules to govern their members' business conduct. When SROs exercise their quasi-governmental power to make rules, they escape the normal antitrust scrutiny to which a trade association would otherwise be subject.

The SEC has the authority to investigate potential violations of the statutes it administers and its own or SRO rules, including the authority to compel testimony and production of evidence. If the SEC detects a violation or prospective violation, it can bring a civil enforcement action in federal court seeking an injunction or monetary penalty.

The SEC also runs an internal court system consisting of administrative law judges (ALJs) appointed by the SEC itself. At present, the SEC can bring virtually all types of civil cases before an ALJ, which conducts a court-like process without a jury. An ALJ's decision is appealable to the SEC's five Commissioners acting in a quasi-judicial capacity and, from there, to a federal appeals court. However, the latter appeal is limited primarily to issues of law rather than factual disputes. This is consequential because the SEC tends to win more frequently before ALJs than in court proceedings (Zaring, 2015). The sanctions available in these internal proceedings include civil fines, cease and desist orders, and bans on working in the securities industry or serving as a public company officer or director.

In general, the willful violation of a securities statute or an SEC or SRO rule constitutes a crime. The Department of Justice (DOJ) prosecutes federal crimes, which are adjudicated in the regular federal court system. The SEC may transmit evidence of criminal behavior to the Attorney General for use in prosecution.

1.4 Regulatory Techniques

Mandatory disclosure is the dominant technique of securities regulation. Companies that issue securities must make company-specific disclosures at the time of sale. Publicly-traded companies must make periodic and episodic disclosures. Securities professionals must make various disclosures to their customers designed to expose conflicting interests and to regulators for oversight and enforcement purposes.

The disclosure concept underlying the federal securities laws differs from the "merit review" approach of some state securities laws, also known as Blue Sky laws, which may give the administering officer or agency the discretion to disallow offerings it deems substantively unfair (Mahoney, 2003). In 1996, Congress amended the Securities Act of 1933 to pre-empt state registration requirements for offerings of most securities listed or authorized for listing on a national securities exchange, among others. States may continue to require notice filings for those offerings and impose related fees and to regulate offerings of many types of unlisted securities.

The main securities statutes and SEC regulations thereunder prohibit fraud, and sometimes misrepresentation short of fraud, in connection with the activities they regulate—the purchase or sale of securities, the solicitation of a proxy, the conduct of a tender offer, the giving of investment advice, etc. In many circumstances, these prohibitions reach more conduct and more potential defendants than the common law of fraud. They were motivated in part by Congress's belief that it was too difficult for a plaintiff to sue successfully for common law fraud in connection with securities transactions.

Licensing is another standard technique. Exchanges, broker-dealers, investment advisers, clearing agencies, transfer agents, and other categories of market professionals must register with the SEC. Statutes prescribe a set of qualifications for registration. The SEC generally has supervisory authority over registered entities.

The SEC's governing statutes impose detailed conduct of business rules on certain registered entities, including exchanges and retail investment funds. SEC and SRO rules regulate the business conduct of other market professionals such as broker-dealers and investment advisers. The Trust Indenture Act of 1939 regulates the substantive content of indentures, the detailed contracts governing publicly-offered debt securities.

Through a historical quirk, the SEC has jurisdiction principally over the cash securities markets, options on securities and security indexes and the markets that trade them, and the single-security derivatives market, while the Commodity Futures Trading Commission (CFTC) regulates the bulk of the derivatives markets. Some of the principles discussed in this monograph will be relevant to derivatives regulation, but it will not survey that field.

In the United States, corporate (or company) law is primarily state law. A 19th century judicial doctrine called the "internal affairs" rule states that the governance of a corporation—the relative powers and obligations of shareholders, managers, and directors—is set by the state of incorporation, regardless of the location of the corporation's assets, managers, or shareholders. While it has eroded around the edges, particularly in California, the internal affairs doctrine remains largely in place as a constraint on state (but not federal) regulation of corporate governance. This creates a form of competition among states to charter corporations, a competition long since won by Delaware.

One state's control over the governance of corporations doing business nationwide touched off a century-long debate over whether corporate law should be federalized (Romano, 1987). The debate was particularly sharp during the New Deal era, when securities law became a federal responsibility. Some New Dealers advocated mandatory federal chartering of public companies, an idea that has recently regained political traction.

While these arguments did not prevail in the main, they have produced victories on specific governance issues. The Exchange Act regulates proxy voting by public companies. Provisions added by the Williams Act regulate tender offers. The Sarbanes–Oxley and Dodd–Frank acts contain multiple discrete governance provisions summarized in Section 2.3 below. In the United States, accordingly, corporate governance is a hybrid of federal rules enacted as part of securities statutes and state rules enacted as part of corporate codes.

1.5 The Political Economy of Securities Regulation

Economists employ two broad theories of the purposes of and the forces generating regulation. One is a public-interest theory in which the purpose is to correct market failures that interfere with efficient allocative outcomes. Economic historians sometimes trace this perspective to Henry Sidgwick (Medema, 2007). The other is a private-interest theory articulated by Stigler (1971) and refined by Peltzman (1976) and others.

It contends that regulation arises from the intersection of the interests of private economic agents and government agents and its primary purpose is redistribution, typically from consumers to producers or among producers.

A detailed treatment of these broad perspectives on political economy is beyond the scope of this work. One's choice of theory, however, affects one's priors about regulatory costs and benefits, which as we will see are difficult to measure. As Mulherin (2007) observes, under the public-interest theory, regulatory imperfections, such as fixed compliance costs that disadvantage smaller firms, are undesired but necessary evils. Publicly-interested legislators and regulators will try to minimize them when possible in pursuit of Pareto improvement. Under the private-interest theory, by contrast, these distributive consequences are features, not bugs, that serve the interests of the winning political coalition. This implies that the effects of regulation will frequently not be well-aligned with social interests.

Real-world regulatory systems probably do not conform perfectly to either theory, but are the product of mixed motives. In that case, part of the evaluative task is to distinguish those regulations that effectively serve the public from those that serve primarily private interests.

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