Why the SEC Has Failed – Where are the customers' advocates?

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The Declaration of Independence, believed to be mainly the work of Thomas Jefferson, states that governments "derive their just powers from the consent of the governed." Strange as it seems, the political reality expressed by this famous document also explains why the SEC and other administrative agencies have failed in their mission.

Administrative agencies generally are created to protect the public from the harm that may be inflicted by some industry. The Interstate Commerce Commission was perhaps the first federal administrative agency. It was created in 1887 because of the harm inflicted on the US economy by railroads engaged in predatory pricing. A series of bank panics in 1873, 1893 and 1907, and resulting national recessions, led to the formation of The Federal Reserve Bank in 1913. Congress instituted the Securities and Exchange Commission in 1934. At that time, the voting public and Congress strongly believed that the fraudulent antics of the securities industry were the primary cause of the Great Depression, an enormous social calamity and economic disaster.

We are in the throes of a major banking panic. The country's largest banks are on taxpayer life support. Hundreds of smaller banks are zombies, hanging on only because the FDIC has not yet determined to put them out of their misery.

The Madoff firm, now undergoing SIPC liquidation, was a broker-dealer, an institution that is the most heavily regulated of any business entity overseen by the SEC. Nonetheless, a commonplace Ponzi scheme running into the tens of billions managed to escape the highly touted regulatory oversight of the SEC and its handmaiden, FINRA. The misallocation of resources resulting from this regulatory failure alone, if invested in General Motors, would probably have staved off its imminent collapse. Coming on the heels of a failed investment banking industry, also regulated by the SEC, the Madoff fraud is truly shocking.

The administrative agencies created to protect the public from banking panics and frauds in the securities industry have failed in their missions. Only blind optimism can sustain the hope that this country can escape a major recession accompanied by widespread unemployment and untold social calamity. Anger will replace fear and as night follows day, the voting public will demand change. We live in a democracy, and Congress will respond to the will of the people. Therefore, I think

it is entirely likely that existing regulatory agencies will be scrapped and new ones created to fill the void.

Since those who cannot learn from history are doomed to repeat it, it is worth considering how we found ourselves in this sorry state of affairs.

While administrative agencies are created to protect the public, they regulate someone else – persons working in industries that in some way threaten the public welfare. In other words, the regulated are a different crowd than the beneficiaries of regulation.

Nonetheless, Jefferson's words are still true: Regulators regulate by consent of the regulated. As a practical matter, regulators are unable to do their job effectively without good information about the industries they regulate. That information is, in turn, known only by the regulated. The cooperation of the regulated is therefore essential for the regulator to do its job.

After a time, this system of information flow tends to create a cozy relationship between the regulated and the regulator. As regulated entities feed information to the regulator, they gain access—the regulated have many opportunities to complain about "unnecessary" and "burdensome" regulations, request special rules and exceptions, and influence the course of rulemaking. Some employees and attorneys of the regulated join the agency and become regulators. They bring their practical knowledge into the agency, which improves its regulatory insights. However, their experience is in presenting the arguments and causes of industry participants, so their perspective tends to lean in favor of their former clients or employers, whether consciously or unconsciously. The same principle works in reverse. The best employment opportunities for members of an agency's staff exist in the businesses regulated by an agency or in the law firms and accounting firms that represent those businesses. Good examples of this regulatory revolving door involving the SEC are legion.

I don't think there is anything wrong with any of this. People who devote a few years of their career to public service are to be admired and praised. I also don't think there is anything immoral or improper with SEC staffers finding jobs in the securities industry. We all have to eat.

There is, however, the public's interest to be considered, the primary reason for the agency's existence.

John White, the retiring Director of the Division of Corporation Finance was, prior to joining the SEC a couple of years ago, an attorney at Cravath, Swain & Moore, where he represented issuers raising money in securities offerings. In his farewell speech to the American Bar Association on November 21, he put his finger on the

problem. He pointed out that although the Division of Corporation Finance works closely with issuers' counsel, auditors and other advisors – in other words, the "regulated"—the Division has only limited contact with "the investor," the public the SEC was instituted to protect. "We constantly think and talk about the "investor," Mr. White observed, "but who is this?"

The reason for this confusion, as in so many facts of life, is economic. Issuers, broker-dealers, exchanges all are regulated entities with plenty at stake economically in the SEC's decisions. They take a keen interest in the rules promulgated by the SEC, and in the administration and enforcement of those rules. These regulated industries pay high-priced lawyers, accountants and lobbyists to influence the outcome. The success or failure of their business may very well depend on the adoption or revocation of some rule, or in its interpretation and enforcement.

The investing public is too defuse and unorganized to hire advocates to represent its side of things before the SEC. Justice William O. Douglas, the renowned corporate lawyer and Supreme Court jurist that from 1937 to 1939 served as the SEC's chairman declared of the SEC: "We are the investor's advocate." It isn't true. The SEC doesn't know enough about the investing public to serve as the investor's advocate. The investing public has no advocate.

If we are to learn from the painful lessons of history, we must appoint someone to act as the investing public's advocate before whatever agency assumes the functions now performed by the SEC or the Fed or the other government agencies that regulate the financial services industry. That advocate should comment on every rule proposal, no matter how small, and express the public's views of the justice handed out by administrative law judges and the decisions of enforcement to pursue or not to pursue certain causes.

The advocate need not be one person or firm. Perhaps as a pre-requisite to bringing a class action, a law firm would need to show that it spent some time as the investing public's advocate. Or perhaps rotating advocates should be chosen through a government procurement process. There is no reason why the taxpayer should not pay to receive advocacy that will compete effectively with the advocates that represent the interests of the regulated. To avoid corruption, this is not a job that any one person or firm should hold for very long.

How will this advocate obtain the information it needs to represent the public interest? How does anyone obtain information? Companies interested in public opinion for the sake of their businesses organize focus groups, generate blogs, hire pollsters. This is the age of sophisticated information gathering.

The lesson history teaches us is that to protect investors from fraud, market failure and economic collapse, we need to hear from them more often, before crisis strikes.