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THE MYTH OF "REREGULATION": THE INTEREST GROUP DYNAMICS OF REGULATORY CHANGE IN THE FINANCIAL SERVICES INDUSTRY

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I. INTRODUCTION

The press has made much in recent months of what it takes to be a shift in public opinion away from support of the so-called "Reagan revolution," which purportedly ushered in an era of *laissez faire*, and towards greater support of governmental intervention in all sectors of private life.¹ Consistent with this purported shift in public opinion, politicians are voicing renewed enthusiasm for all sorts of regulatory initiatives.² Along these lines, one senator recently has gone so far as to declare himself a "born again" reregulator.³

The purpose of this Article is to discuss this supposed trend towards reregulation within the framework of the modern economic theory of regulation, often referred to as Public Choice.⁴ In doing so, I wish to make the following points. First, the legal rules we observe at a particular time are the outcome of a political struggle among special interest groups for favorable regulation. Legal rules reflect the political power of special interest groups and the efforts of politicians to maximize the political support they receive from interest groups' constituencies. Under the public choice model

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1. Koeppe, *Rolling Back Regulation*, TIME, July 6, 1987, at 52 ("59% of consumers think the breakup [of the phone company] is a 'bad thing.'"); *Deregulation Disaffection*, NAT'L. REV., Aug. 28, 1987, at 18 ("Today . . . there is a renewed effort to associate 'deregulation' with chaos."); *Re-Regulation Rag*, THE NEW REPUBLIC, May 18, 1987, at 5 ("After six years of laissez-faire rhetoric under the Reagan administration, regulation may be coming back into fashion."); Berke, *Deregulation has Gone too Far, Many Tell the New Administration*, N.Y. Times, Dec. 11, 1988, at 1, col. 1 (reregulation expected because free market is no longer as popular as it used to be); Wall St. J., Apr. 24, 1987, at 52, col. 1 ("[T]he SEC's aggressive campaign against insider trading and its several investor-protection initiatives parallel a regulatory resurgence in other areas."); Wall St. J., Apr. 22, 1987, at 72, cols. 1 & 3 ("The renewed vigor at [OSHA] is part of a regulatory revival on a broad range of issues where there is public pressure. . . . Half of those surveyed in a recent . . . poll said there should be more government regulation of on-the-job health and safety, while only 6% said there should be less. . . . 'There is greater public support for government intervention to deal with these problems.'").

2. See N.Y. Times, July 20, 1988, at A20, col. 1 (Democratic Party Platform: "[I]t is time for . . . reversing the trend of . . . deregulation. . .").

3. Legal Times of Washington, April 6, 1987, at 1.

4. See generally *Symposium on the Theory of Public Choice*, 74 VA. L. REV. 167-518 (1988).

of legislative behavior that I will employ in this Article, the economic interests of the regulated have far more influence on the course of legislative outcomes than does ideology. Therefore, I will argue, it is inappropriate and misleading to discuss regulatory changes in terms of whether the general political climate favors more or less regulation. The better guide to new regulatory initiatives is whether there are changes either in the nature of the special interest groups who demand legislation, or in the nature of the members of Congress who supply legislation. It is these changes in the underlying supply and demand conditions for law, rather than changes in the ideological climate of the electorate, that lead to the generation of new legal rules.

Consistent with the model of the lawmaking process developed here, and despite press reports to the contrary, we should not expect to observe a general trend toward greater regulation. Instead, we should expect to observe regulation and deregulation occurring *simultaneously*—even in closely related areas—because both regulation and deregulation reflect changes in the equilibrium conditions that provide the theoretical underpinnings for the interest group theory of regulation and not anything so amorphous as shifts in public opinion.

To illustrate this hypothesis, this Article will look at two major regulatory initiatives in the financial services industry. As will be seen, just as major new regulatory initiative is underway in takeovers, we observe an even more sweeping deregulatory initiative in the area of new powers for commercial banks. This Article describes the underlying political economies in these two areas to show that the interest group theory of regulation provides an explanation for the patterns of regulation we observe that is more plausible than any theory that predicts that regulations will change whenever the political philosophy of the public changes.

Second, this Article attempts to link the economic theory described in the first part of the Article to the shifts in public sentiment described in the introduction. While ideology and public opinion do affect political outcomes, collective action problems, such as rational ignorance and free-riding, allow entrepreneurial politicians to *shape* public opinion to facilitate interest group wealth transfers. In other words, while popular belief holds that public opinion often shapes political outcomes, the opposite appears to be true. In general, the public's opinion of the good is *shaped* by the outcomes generated by the political process, and that process, in turn, is driven by an interest group dynamic.

Part I of this Article describes the economic theory of regulation. It argues that this theory, rather than any purported shift in public preferences in favor of increased regulation, better explains any recent trend towards increased regulatory activity. Similarly, the economic theory of regulation provides a more robust explanation of the current trends in lawmaking than does a theory that presumes lawmakers to be acting in the "public's interest." Parts II and III illustrate the general points made in Part I with specific examples from the financial services industries.

Part II examines the current trend towards deregulation of the commercial banking industry. Clearly this trend toward deregulation is incon-

sistent with any general trend towards greater regulation of the private sector. The deregulatory trends in commercial banking appear particularly inconsistent with any notion of a general trend towards reregulation. The increasing rate of bank failures and the financial difficulties of the Federal Deposit Insurance Corporation (FDIC) and the Federal Savings and Loan Insurance Company (FSLIC) provide those in favor of expanding the scope of federal regulation with strong arguments for increasing, rather than reducing, the regulations governing banks. But consistent with the interest group approach taken here, the trend is in the opposite direction. The expansion of commercial banking powers to underwrite municipal revenue bonds and corporate debt, including junk bonds, and the proposed repeal of sections of the Glass-Steagall Act are examples of this trend toward deregulation.

Part III considers the move towards increasing insider trading regulations. Here the trend is decidedly in favor of increasing the scope of regulation. This trend is not due to any new philosophy on the part of the regulators, or to any shift in public opinion. Rather, consistent with the economic theory of regulation, the trend is due to exogenous changes in legal rules that have led to an increased demand for regulation on the part of the regulated. Finally, Part IV considers the twin roles of ideology and public opinion in the interest group model presented in the previous sections.

II. THE ECONOMIC THEORY OF REGULATION

In a nutshell, the economic theory of regulation posits that "public policy emerges from the struggle of interest groups to redistribute the wealth of society in their favor. . . ."⁵ According to this view of the legislative process, laws are supplied to those interest groups (or coalitions of interest groups) that outbid rivals for favorable legislation.⁶ The currency used in the bidding comes in "the form of campaign contributions, votes, implicit promises of future favors, and sometimes outright bribes."⁷

One need not believe that politicians are greedy, evil, or venal to embrace the economic theory of regulation's hypothesis that politicians

5. Landes & Posner, *The Independent Judiciary in an Interest Group Perspective*, 18 J.L. & ECON. 875, 876 (1975).

6. *Id.* at 877; see Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974) (reviewing literature); Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (articulating economic theory of regulation in precise economic terms); see also Posner, *Economics, Politics and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 265 (1982) ("legislation is a good demanded and supplied much as other goods, so that legislative protection flows to those groups that derive the greatest value from it, regardless of overall social welfare"); Becker, *Pressure Groups and Political Behavior*, in CAPITALISM AND DEMOCRACY: SCHUMPETER REVISITED, 120, 124 (R. Coe & C. Wilber, eds. 1985) ("taxes, subsidies, regulations, and other political instruments are used to raise the welfare of more influential pressure groups. Groups compete within the context of rules that translate expenditures on political pressure into political influence and access to political resources.").

7. Landes & Posner, *supra* note 5, at 877.

enact laws that exalt the preferences of narrow special interest constituencies over the public good. The better view is that the preferences of organized interest groups inevitably will triumph in the political arena because of politicians' need to maximize political support to stay in office. In a governmental system in which politicians must compete with one another for votes, the observation that politicians must garner political support to survive is a tautology.

A major contribution of the economic theory of regulation is the recognition that well-organized special interest groups are better able to provide political support than are diffuse, poorly organized members of the public-at-large. As such, those politicians unable or unwilling to satisfy their interest group constituents will be driven from office by rival politicians more capable of satisfying interest group demands. To take a simple example, imagine a proposed piece of legislation that will cost everybody in the U.S. \$1.00, and will transfer \$230 million to a particular interest group. The individual members of the public on whom this additional \$1.00 tax is to be levied cannot rationally oppose the wealth transfer, regardless of its merits. The costs of obtaining information about the effects of the proposed transfer on the individual's total utility, and of organizing into an effective political coalition to fight it would be many times greater than \$1.00. Consequently, it is far less costly for individual members of the public to remain ignorant of most wealth transfers than it is for individual members of the public to incur the information and organization costs necessary effectively to oppose wealth transfers.⁸ By contrast, the interest group beneficiary of the regulation has an incentive to expend resources up to the full amount of the proposed wealth transfer.⁹

Simply put, the economic theory of regulation posits that legislatures pass laws to benefit those groups that are able to pay for the laws with promised political support. The costs of these laws are borne by those who are in the worst position to object to them—the amorphous and disaggregated public. Thus, the realities of the political marketplace provide strong incentives for politicians themselves to search actively for issues in which the winners are easily identified and the losers are poorly identified.¹⁰ The losers pay for legislation that benefits special interest groups with higher

8. R. McCORMICK & R. TOLLISON, *POLITICIANS, LEGISLATION, AND THE ECONOMY: AN INQUIRY INTO THE INTEREST-GROUP THEORY OF GOVERNMENT* 16-17 (1981). The phenomenon described in the text has been described as "rational ignorance." See M. OLSON, *THE RISE AND DECLINE OF NATIONS* 25-36 (1982).

9. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807, 812 (1975); Rogerson, *The Social Costs of Monopoly and Regulation: A Game-Theoretic Analysis*, 13 BELL J. ECON. 391, 391 (1982).

10. Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 229 (1986). "Market forces provide strong incentives for politicians to enact laws that serve private rather than public interests and hence statutes are supplied by lawmakers to the political groups or coalitions that outbid competing groups." *Id.*

taxes, increased regulatory burdens at all levels, and higher prices for goods and services.¹¹

Within the economic theory of regulation, marginal conditions still hold, and at the relevant margins, passing legislation that benefits special interest groups is not without costs for politicians. Certain individuals and groups are likely to oppose new legislation, particularly the legislation that obviously serves no legitimate public purpose, or that plainly benefits one special interest group at the expense of another. To invoke the economists' lexicon, politicians face an opportunity cost when they pass laws. The benefits they receive in the form of increased political support from certain groups are offset by the opposition that the passage of such laws brings from other groups. Operating under these constraints, the politicians' goal is to maximize net political support.¹²

To maximize net political support, politicians have an incentive to shape issues so that it is difficult for the losers to learn about their effects. One way to do this is to make special interest oriented legislation *appear* to be in the public interest by couching it in public interest terms "to avoid the political fallout associated with blatant special interest statutes."¹³ Another way to accomplish a similar result is to make the statute ambiguous or very complicated, thus making it difficult for the public to discern the true ramifications of a particular statutory enactment.¹⁴

Still another strategy that political support maximizing politicians can employ is to act in an entrepreneurial role and actually seek out and identify issues and concerns on behalf of their constituents. Such entrepreneurial politicians then can educate their constituents about why they should invest resources to support the issue that the politician has identified. Accordingly, politicians are able to form their own interest groups around issues of their choosing. Similarly, entrepreneurial politicians can use "indoctrination and selective recruitment" to increase the homogeneity of the interests of the groups they organize.¹⁵ Such indoctrination and selective recruitment also ensures that the relevant interest groups will have strong preferences for the laws that their entrepreneurial politicians propose.

An important element in the public choice model is the ability of special interest groups to control the flow of information that political decision-makers use in the lawmaking process. As noted above, members of the general public have little or no incentive or ability either to oppose laws that are contrary to their interests, or to promote laws that are generally

11. Macey, *Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 471, 478-80 (1988).

12. Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976).

13. Macey, *supra* note 10, at 233. In an earlier article I referred to this phenomenon as the passage of "hidden-implicit" statutes. *Id.*

14. Of course, these strategies are not without costs. One cost is that vague or complicated statutes are not as valuable to interest groups because the courts may misconstrue the statutes. *Id.*

15. M. OLSON *supra* note 8, at 25.

beneficial. The effect on the public is so diffuse that any individual

will reap only a minute share of the gains from whatever sacrifices the individual makes to achieve [the] common interest. Since any gain goes to everyone in the group, those who contribute nothing to the effort will get just as much as those who made a contribution. . . . The paradox, then, is that (in the absence of special arrangements . . .) large groups, at least if they are composed of rational individuals, will *not* act in their group interest.¹⁶

By contrast, relatively small groups sometimes can overcome this collective action problem and organize into effective political coalitions. Such groups, in effect, monopolize the flow of information that goes to decisionmakers, and present only one side of the issue, thereby making even well-intentioned politicians believe that they are acting in the public interest.¹⁷ Such politicians find that interest groups play an extremely important role in supplying information, particularly on technical subjects.¹⁸

A final way that entrepreneurial politicians can maximize political support is by threatening to pass legislation that harms special interest groups.¹⁹ By making such threats politicians can obtain political support in exchange for regulatory forbearance.²⁰ This tactic is useful particularly where a group has made specific capital investments that can be expropriated in the political process.²¹

Under the economic theory of regulation, regulatory change does not come about because of ideological mood swings in the country, but rather because of some change in the underlying political equilibrium that causes politicians to believe that they can maximize their overall political support by supporting regulatory change. Exogenous factors, such as technological innovation or the emergence of new, low cost substitutes for particular products, may create a new demand either for regulation, or for deregulation.

Just as the economic theory of regulation predicts that we will observe a constant barrage of new regulatory initiatives, it also predicts that we will observe deregulation from time to time. For example, as Gregg Jarrell has shown, when the New York Stock Exchange (NYSE) functioned as an effective monopoly, the NYSE expended sufficient political resources to

16. *Id.* at 18. Economists refer to this phenomenon as a "free-rider" problem.

17. See Macey, *supra* note 10, at 231 ("Those affected by the regulation (the general public) cannot overcome the free-rider problem that prevents the presentation of information favorable to the public interest. Thus, the cost of obtaining and disseminating information about legislative issues often results in passage of special interest legislation by legislators who really believe they are acting in the public interest.") (footnotes omitted).

18. G. WILSON, *INTEREST GROUPS IN THE UNITED STATES* 113-114 (1981); N. ORNSTEIN & S. ELDER, *INTEREST GROUPS, LOBBYING AND POLICYMAKING* 75-76 (1978).

19. Macey, *supra* note 10, at 223 n.2.

20. *Id.*

21. *Id.*

convince Congress and the Securities and Exchange Commission (SEC) that it would be in their interest to permit the NYSE to continue to engage in price fixing for brokerage commissions.²² But eventually low-cost alternatives to block trading on the NYSE began to emerge, and regional exchanges began to undermine the monopoly power of the NYSE. These exogenous events reduced the net political demand for regulation by the NYSE in this area because competitors offering lower commission rates to traders were able to attract market share away from the NYSE. This situation ultimately led to the deregulation of fixed commission rates on the NYSE.²³ As Mancur Olson has observed, as society develops and interest groups invent sophisticated techniques for combatting collective action problems, such as free-riders, interest group demand for regulation will increase and we will observe more and more government activity.²⁴

From a theoretical perspective, the appeal of the economic approach to legislation is simple. Unlike its rival, which naively posits that public actors subsume their own preferences for the preferences of the community, public choice theory assumes that people generally act to further their own, narrowly defined self-interest over a wide range of issues. Virtually no one denies the premise that individuals pursue their own self-interest in market settings. No one has advanced a convincing explanation for why political actors pursue their own self-interest when acting privately, but magically become altruistic when acting politically.²⁵ Thus, it is not surprising that economists,²⁶ and other academics²⁷ almost universally accept the public choice theory of regulation. Nor is the embrace of the interest group theory of the political process linked to any particular ideology; rather, the interest group theory of government is “[e]spoused by an odd mixture of welfare state liberals, muckrakers, Marxists, and free market economists. . . .”²⁸

Perhaps the most convincing reason that the economic theory of regulation has a greater claim to validity than its rival (which simply posits that legislation is passed by benevolent, “other-regarding” decisionmakers whose

22. Jarrell, *Change at the Exchange: The Causes and Effects of Deregulation*, 27 J.L. & ECON. 273 (1984).

23. *Id.* at 307.

24. M. OLSON, *supra* note 8.

25. This is not to say that such schizophrenia has not been asserted. See S. KELMAN, *MAKING PUBLIC POLICY: A HOPEFUL VIEW OF AMERICAN GOVERNMENT* 22 (1987) (“There is the elementary fact that political decisions apply to an entire community. That they do so encourages people to think about others when taking a stand. This is in contrast to making personal decisions, when people think mainly of themselves.”).

26. Kalt & Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 AM. ECON. REV. 279 (1984).

27. R. POSNER, *THE FEDERAL COURTS* 271 (1985) (describing “shift in scholarly thinking about legislation from a rather naive faith in the public-interest character of most legislation to a more realistic understanding of the importance of interest groups in the legislative process”).

28. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 335 (1974).

only interest is in advancing the public good) is that overwhelming empirical evidence supports the economic theory of regulation.²⁹ To illustrate the general theory described above, the following sections will present specific examples of interest group-oriented political behavior drawn from the financial services industry. The political outcomes we observe are not well-explained on the basis of either "public opinion" or the public's sentiments regarding the appropriate overall level of government intervention in the private sector. Rather, consistent with predictions of the economic theory of regulation, the most likely explanation for the eclectic pattern of law-making we observe is that it reflects the systematic domination of the political process by interest groups who promote the adoption of legal rules that serve their own, selfish ends. Thus, it is unsurprising that we observe major drives towards deregulation in one area—bank powers—at the same time that we observe major drives towards reregulation in another area—insider trading. In both cases interest group preferences prove far more important than ideological consistency.

III. DEREGULATION IN THE COMMERCIAL BANKING INDUSTRY: AN INTEREST GROUP PERSPECTIVE

Despite unusually plausible reasons for imposing greater regulatory safeguards on the securities activities of commercial banks, the trend clearly is in the opposite direction. Indeed, major initiatives of unprecedented scale are currently underway to revise or even to repeal Glass-Steagall.³⁰ This trend plainly runs counter to any supposed general shift in favor of greater reregulation of private ordering.

A. *The Existing Legal Framework: The Glass-Steagall Act*

In the wake of the unprecedented number of bank failures of the Great Depression, Congress laid out the basic infrastructure of modern U.S. banking regulation in the Banking Act of 1933. The Banking Act of 1933 established a system of federally sponsored deposit insurance, prohibited the payment of interest on demand deposits, empowered the Federal Reserve Board to fix ceilings on the interest banks paid on time deposits, and separated commercial banking from investment banking in the United States.

29. For studies employing empirical tools to test the economic theory of legislation, see R. MCCORMICK & R. TOLLISON, *supra* note 8; M. OLSON, *supra* note 8; W. M. Crain, *On the Structure and Stability of Political Markets*, 85 J. POL. ECON. 829 (1977); Crain & Tollison, *Campaign Expenditures and Political Competition*, 19 J.L. & ECON. 177 (1976); Jarrell, *supra* note 22; Kalt, *The Costs and Benefits of Federal Regulation of Coal Strip Mining*, 23 NAT. RESOURCES J. 893 (1983); Macey & Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315; Maloney & McCormick, *A Positive Theory of Environmental Quality Regulation*, 25 J.L. & ECON. 99 (1982); Pashigian, *The Effect of Environmental Regulation on Optimal Plant Size and Factor Shares*, 27 J.L. & ECON. 1 (1984).

30. See *infra* notes 53-57 and accompanying text (describing regulatory initiatives currently underway).

The section of the Banking Act of 1933 that separates commercial banking from investment banking is the so-called Glass-Steagall Act.³¹

The Glass-Steagall Act (the Act) consists of four principal components. Section 16 prohibits commercial banks, with certain exceptions, from underwriting, selling, and dealing in securities.³² While section 16 approaches the separation of commercial and investment banking from the perspective of the commercial banks, section 21 approaches the issue from the perspective of the investment banks, by prohibiting any person "engaged in the business of issuing, underwriting, selling, or distributing . . . stocks, bonds, debentures, notes or other securities" from engaging in the core commercial banking functions of administering checking or savings accounts.³³ Section 20 ostensibly regulates the ability of bank holding companies to conduct securities activities through affiliates, such as subsidiaries. But, unlike sections 16 and 21, section 20 does not purport to impose a complete ban on the investment banking activities of bank affiliates. Rather, section 20 only forbids affiliations between banks and firms "engaged principally in the issue, flotation, underwriting, public sale or distribution . . . of stocks, bonds, debentures, notes, or other securities."³⁴ Finally, section 32 bars individuals involved in any aspect of the investment banking industry from serving as an officer, director, or employee of a national or state chartered member bank.³⁵

The Glass-Steagall Act is a paradigmatic example of a special interest group-oriented statute described above.³⁶ Consistent with the hypothesis that

31. The Glass-Steagall Act is the popular name for certain parts of the Banking Act of 1933. The Banking Act of 1933, Pub. L. No. 66, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). The sections of the Banking Act that contain Glass-Steagall are sections 16, 20, 21, and 32. These sections are "usually the intended reference when the term Glass-Steagall is used." Note, *A Banker's Adventures in Brokerland: Looking Through Glass-Steagall at Discount Brokerage Services*, 81 MICH. L. REV. 1498, 1501 n.12 (1983).

32. 12 U.S.C. § 24 (Supp. 1983). Section 16 contains exceptions that allow commercial banks to sell general revenue municipal bonds and debt obligations of the United States government. *Id.* In addition, the so-called agency exception permits commercial banks to make purchases and sales of securities "without recourse, solely upon the order, and for the account of, customers." *Id.*

33. *Id.* at § 378(a)(1) (Supp. 1988).

34. *Id.* at § 377 (1945).

35. *Id.* at § 78 (1945).

36. For elaborations of the interest group dynamic that led to the passage of the Glass-Steagall Act, see Benston, *Federal Regulation of Banking: Analysis and Policy Recommendations*, 13 J. BANK RES. 216, 222 (1983) ("the evidence supports the belief that the investment bankers and underwriters were concerned about severe competition from banks and bank affiliates and sought (successfully in 1933) to eliminate these competitors"); Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1 (1984); Shughart, *Regulating Investment Banking: The Glass-Steagall Act in Public Choice Perspective* (draft on file with author); see also Easterbrook, *Foreword: The Court and the Economic System*, 98 HARV. L. REV. 4, 57 (1984). But see Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672 (1987) (asserting that Glass-Steagall served certain vague public policy ends).

such statutes will mask private interest purposes under ostensible public interest trappings,³⁷ a variety of public-regarded purposes generally are attributed to the Act. Glass-Steagall purportedly ensures that banks will confine their activities to traditional avenues that generally are considered safe, such as commercial lending.³⁸ If commercial banks refrain from investment banking, supporters argued that a repetition of the massive wave of bank failures of the Great Depression could be avoided.³⁹

This argument is implausible on its face. The vast majority of banks that failed during the Depression were small, state chartered banks, located away from major financial centers, and not in the securities business.⁴⁰ The reality is that "factors other than securities dealings were more important in explaining the wave of bank failures that followed the Crash."⁴¹ Indeed, the activities of securities affiliates were identified as the cause of only one bank failure, the failure of the Bank of the United States, out of over 9,000 bank failures between 1929 and 1933.⁴²

Perhaps, and more importantly, the proposition that all investments in stock or securities are inherently riskier than all commercial lending activities is simply ridiculous. Clearly "bank ownership of high grade, blue chip stock, which is prohibited by the Act, is inherently far less risky than many bank loans such as those to third world countries or to real estate investment trusts."⁴³

Another policy theme often trumpeted in defense of the Glass-Steagall Act is that the law benefits the public by eliminating conflicts of interest faced by banks engaging in the securities business. The public policy supposedly being furthered here is quite obscure. The goal seems to be to eliminate the "subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business."⁴⁴ But, as Fischel, Rosenfield, and Stillman

37. See *supra* note 13 and accompanying text (noting that politicians make special interest oriented legislation appear to be in public interest by couching legislation in public interest terms).

38. See Fischel, Rosenfield & Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 319-20 (1987).

39. 75 CONG. REC. 9887 (1932) (remarks of Senator Glass) (blaming securities affiliates of banks for "unprecedented disaster which has caused this almost incurable depression"); Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 BANKING L.J. 483, 524-26 (1971).

40. Shughart, *supra* note 36, at 9.

41. *Id.*

42. *Id.* at 8-9; Flannery, *An Economic Evaluation of Bank Securities Activities Before 1933*, in DEREGULATING WALL STREET, COMMERCIAL BANK PENETRATION OF THE CORPORATE SECURITIES MARKET, 67-87 (I. Walter ed. 1985).

43. Macey, *supra* note 36, at 11.

44. *Investment Co. Inst. v. Camp*, 401 U.S. 617, 630 (1971); see *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 145 (1984) (quoting *Camp*); see also 75 CONG. REC. 9912 (1932) (remarks of Sen. Bulkey):

[T]he banker who has nothing to sell his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker

showed in an important recent article, the public interest argument here is not only obscure, it is wrong.⁴⁵ Indeed,

a strong argument can be made that the advice provided by banks would be more, not less, disinterested if banks and their affiliates could offer other financial products. For example, because banks cannot offer many types of investments, they have an incentive to promote debt financing instead of a mix of debt and equity financing. Consider as an analogy a rule prohibiting law firms from offering services to both partnerships and corporations. One class of law firm would market and promote the partnership form, while others would market and promote the corporate form. . . . [It would promote the delivery of unbiased legal advice if] businesses could turn to a single law firm for "disinterested" counsel regarding the choice between corporate and partnership organization.⁴⁶

Thus it appears clear that the ostensible public interest justification for Glass-Steagall cannot withstand even the most cursory scrutiny. The public choice explanation for the origins of Glass-Steagall seems far more plausible. By eliminating commercial bank competitors from the investment banking industry and investment banking competitors from the commercial banking industry, the Glass-Steagall Act benefited both industries at the expense of the general public. Glass-Steagall benefited commercial bankers by prohibiting securities dealers from entering the business of deposit banking. Investment banks manage customer margin accounts that easily could be converted into demand deposit accounts. At least for a time Glass-Steagall eliminated this potential source of competition.⁴⁷ Glass-Steagall benefited investment banks by preventing commercial banks from underwriting and dealing in securities. Because the information and expertise needed to make commercial loans are virtually the same as the information and expertise needed to succeed in the securities business, the Act relieved investment banks of a major source of competition.⁴⁸

B. The Situation Today: Deregulation in the Face of Crisis

Despite the strong arguments that the Glass-Steagall Act serves no legitimate public policy purpose and cartelizes the process of capital inter-

who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit or a distribution profit or a trading profit or any combination of such profits.

45. Fischel, Rosenfield & Stillman, *supra* note 38, at 323-30.

46. *Id.* at 325.

47. See Macey, *supra* note 36, at 17-20.

48. In an earlier article I argued that Glass-Steagall was designed primarily to benefit commercial bankers and gained only the acquiescence of the investment banking community. See Macey, *supra* note 36, at 17-20; see also Shughart, *supra* note 36, at 5. It now appears clear that the Act benefitted both industries.

mediation in the economy, the Act is "typically viewed as a public-spirited attempt by Congress to protect depositors."⁴⁹ As will be seen in this section, the public interest justifications for Glass-Steagall have not changed. If anything, the ostensible public interest justifications are stronger now than they have been at any time since the passage of the Act. Nevertheless, recent months have witnessed a massive drive towards deregulation in this area. The source of this demand for the repeal or reform of Glass-Steagall is the same as the source of the initial demand for passage of the Act: organized special interest groups.

There are two reasons why the current debate over repeal of Glass-Steagall is extremely difficult to reconcile with the original public interest justifications for the Act. First, the dramatic rise in the number of failures of federally-insured banks in recent years is unprecedented since the days of the Depression.⁵⁰ These failures are attracting increasing attention in the popular press.⁵¹ Thus, to the extent that those who subscribe to the public interest theory of regulation believe that the provisions of the Glass-Steagall Act are needed to increase bank safety and prevent bank failures, we should observe attempts to bolster rather than to weaken the provisions of Glass-Steagall.

As noted above, Congress also intended the Glass-Steagall Act to benefit the public by keeping banks out of the inherently risky securities industry. Thus, the public interest theory of regulation would predict that we should observe deregulation of commercial banking only if the securities business becomes less risky. It is clear, however, that this is not the case. Indeed, as the stock market "break" of October 19, 1987 and the recent popularity of high-risk corporate junk bonds have made plain, the securities industry is becoming, if anything, more, rather than less volatile.⁵² Thus, the public interest theory of regulation would predict that, at present, we should be observing initiatives to bolster, not to repeal Glass-Steagall. As the next section shows, the reality is to the contrary.

C. *Glass-Steagall: The Economics of Deregulation*

The Spring of 1988 saw the dawn of a major new era in the structure of the financial services industry as the Supreme Court refused to hear a securities industry challenge to a momentous Federal Reserve Board decision.

49. Shughart, *supra* note 36, at 1.

50. Short, *FDIC Settlement Practices and the Size of Failed Banks*, *ECON. REV.* (Fed. Reserve Bank of Dallas), Mar. 1985, at 12.

51. Gorman, *Cracks in the System: Taxpayers May Have to Shell Out Billions to Rescue the Financial Industry*, *TME*, Aug. 29, 1988, at 54-55; Hershey, Jr., *FSLIC's Need Put at \$50 Billion*, *N.Y. Times*, Aug. 4, 1988, at D1, col. 3; Nash, *U.S. Will Announce Huge Quarter Loss for Savings Units*, *N.Y. Times*, June 21, 1988, at A1, col. 1.

52. See *The October 1987 Market Break*, Fed. Sec. L. Rep. (CCH) No. 1271 (Extra Edition) (Feb. 9, 1988); *Report of the Presidential Task Force on Market Mechanisms*, Fed. Sec. L. Rep. (CCH) No. 1267 (Extra Edition) (Jan. 12, 1988); GENERAL ACCOUNTING OFFICE, *FINANCIAL MARKETS: PRELIMINARY OBSERVATIONS ON THE OCTOBER 1987 CRASH* (1988).

The Federal Reserve Board decision allows bank holding companies to underwrite and to deal in all sorts of securities, including commercial paper, mortgaged-backed securities, municipal revenue bonds, and consumer-related receivables. A more recent Fed decision goes still further, permitting commercial banks to underwrite corporate debt—even so-called junk bonds.⁵³ But these are only the latest salvo of a fusillade of deregulatory initiatives. For example, last year the Senate passed a bill that would repeal sections of the Glass-Steagall Act and greatly expand the securities powers of commercial banks.⁵⁴ In addition, the House of Representatives unveiled legislation that would permit banks to underwrite a broad range of securities, but would install restrictions on banks' real estate dealings and insurance activities, and close loopholes in the Glass-Steagall Act.⁵⁵ California and Texas banking representatives have voiced strong opposition to this House bill, but not because they favor maintaining the current regulatory structure. Rather, these banking representatives favor the complete repeal of Glass-Steagall, no prohibition on real estate dealings, and approval of multistate insurance activities by multistate bank holding companies.⁵⁶ In order to account for the recent trends toward repeal and reform of Glass-Steagall in the face of increased market volatility, waves of bank failures, and significant strains on the financial integrity of the federal deposit insurance funds, one must turn to the economic theory of regulation. In a nutshell, the major change that accounts for the demand for deregulation is that because the economic benefits once conveyed by the Act now have become burdensome, important elements in both the commercial banking industry and the investment banking industry now favor repeal of Glass-Steagall. Commercial banks see potentially valuable gains to be made in the business of securities dealing, and investment banks find themselves hampered by their lack of access to low cost sources of funds. Thus, the initial interest group demand for regulation has turned into a demand for deregulation.

Commercial banks particularly are concerned by the ability of investment banks to sell commercial paper. Commercial paper consists of short term promissory notes issued by large, industrial corporations. For a time, commercial paper threatened to replace commercial borrowing as the major source of short-term capital for a number of firms that traditionally had been major commercial banking clients.⁵⁷ The potential of the Glass-Steagall Act to deprive major commercial banks of an important source of business

53. Rehm & Rosenstein, *New Powers Allowed by High Court*, Am. Banker, June 14, 1988, at 1, col. 4; Duke, *Fed Moves to Allow Banks to Underwrite Corporate Debt; Equity Powers Withheld*, Wall St. J., January 19, 1989, at A3, col. 2.

54. S. 1886, 100th Cong., 1st Sess., 134 CONG. REC. S3360 (daily ed. March 30, 1988).

55. Garsson, *St. Germain Bill Eases Limits on Underwriting*, Am. Banker, July 8, 1988, at 1, col. 4.

56. Garsson, *Texas, California Groups Come Out Against Bill Drafted by House Panel*, Am. Banker, July 12, 1988, at 2, col. 1.

57. See Note, *A Conduct-Oriented Approach to the Glass-Steagall Act*, 91 YALE L.J. 102, 115 (1981).

gave such banks a strong incentive to demand reform of Glass-Steagall. Similarly, investment banks, which have been unable to offer federally-insured demand-deposit accounts, have kept such firms from being able to obtain low-cost sources of capital. Investment bankers believe that this has placed them at a competitive disadvantage to commercial banks. Reform of Glass-Steagall is the only way to remove this disadvantage.

When viewed from a public choice perspective, the Glass-Steagall Act contained the seeds of its own destruction from its very inception. When the Act was passed both commercial banks and investment banks benefited from the reduction in competition for their services. For a while the Act artificially curtailed the supply of both investment banking and commercial banking services, allowing existing firms in both industries to enjoy super-competitive returns. But new firms and new products entered these fields and drove profits back down to competitive levels. Over time, all that was left of Glass-Steagall was its anticompetitive elements, and the very firms that once profited from the Act were given reasons to press for its repeal.

IV. THE REREGULATION OF INSIDER TRADING: AN INTEREST GROUP PERSPECTIVE

The preceding section discussed how the current trend towards repeal of the Glass-Steagall Act is consistent with the economic theory of regulation, and inconsistent with a regulatory theory asserting that we can predict regulatory change on the basis of shifts in ideology, public opinion, or the public interest. This section will examine recent regulatory initiatives to increase the regulation of insiders' trading activities and show that reregulation, like deregulation, is best explained by the economic theory of regulation. In this section I will argue that, in sharp contrast to the situation described above, no public policy justification exists for increased regulation of insiders' trading activities. But despite the lack of a public policy justification for increasing insider trading regulation, major regulatory initiatives are underway, and the SEC is aggressively dealing with the problem.⁵⁸ Next, drawing once again on the economic theory of regulation, I will present an interest group explanation for these new regulatory initiatives.

A. *Insider Trading: The Need for New Regulation*

No new regulation is needed in the area of insider trading because recent Supreme Court decisions announced that the SEC's Rule 10b-5⁵⁹ had "brought clarity and coherence to the law of insider trading."⁶⁰ First, in *Chiarella v. United States*,⁶¹ the Supreme Court clarified the definition of

58. See *supra* notes 49-57 and accompanying text (describing current regulatory proposals).

59. 17 C.F.R. § 240.10b-5 (1988).

60. Macey, *From Judicial Solutions to Political Solutions: The New, New Direction of the Rules Against Insider Trading*, 39 ALA. L. REV. 355, 357 (1988).

61. 445 U.S. 222 (1980).

insider trading. The Court held that insider trading liability arises from the violation of a specific contractual relationship between the trader-defendant and the injured party.⁶² The *Chiarella* opinion was a major advance in the development of the law of insider trading because it firmly grounded insider trading liability on precise, well-established, economic notions of property rights in information.⁶³ While previous cases had not been at all clear on the theoretical underpinnings of the rules against insider trading, the *Chiarella* decision made it plain that the obligation to refrain from trading on inside information arises from preexisting contractual relationships between the owners of inside information and their agents. As subsequent cases made clear, while property rights in information are protected, the danger of being wrongfully prosecuted for insider trading is diminished substantially.⁶⁴

In *Dirks v. SEC*,⁶⁵ the Supreme Court further clarified the law of insider trading by developing a rule to deal with the vexing problem of tippee liability.⁶⁶ Like *Chiarella*, *Dirks* advanced the ends of economic efficiency and investor welfare by rejecting the SEC's arguments that the securities laws require equal treatment of all traders, regardless of the resources that have been expended acquiring valuable, firm-specific information.⁶⁷

Just as the law of insider trading was becoming coherent, major regulatory initiatives were introduced to return the law to its former state of confusion and incoherence. First, in the wake of *Chiarella*, the SEC enacted rule 14e-3,⁶⁸ which prohibits anyone from trading while they possess material, nonpublic information relating to a tender offer, if the trader knows or recklessly disregards that the information has been obtained from the offering person, the target, or the target's or offeror's agents.⁶⁹ In addition, for the first time in its history, the SEC abandoned its virtual complete neglect of its enforcement responsibilities.⁷⁰ The SEC brought the enforcement of insider trading to the top of the regulatory agenda,⁷¹ with the top official loudly proclaiming that agents would "come down on insider trading with hobnail boots."⁷² Finally, in 1987, a number of bills were

62. *Chiarella v. United States*, 445 U.S. 222, 233 (1980).

63. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984).

64. See *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983); *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984).

65. 463 U.S. 646 (1983).

66. See Macey, *supra* note 60, at 361-62.

67. *Dirks v. SEC*, 463 U.S. 646, 657-59 (1983).

68. 17 C.F.R. § 240.14e-3 (1988).

69. *Id.*

70. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 8-9 (1980) (cataloguing SEC's failure to enforce insider trading rules).

71. Haddock & Macey, *Regulation on Demand: A Private Interest Model, With An Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 332-35 (1987).

72. Wayne, *Inside Trading by Outsiders*, N.Y. Times, May 27, 1984, § 3, at 1, col. 2.

introduced in Congress to expand the current scope of insider trading law.⁷³ As this section has made clear, these new rules cannot be explained on the basis of any legitimate public policy needs, such as deficiencies or shortcomings in the existing law. Rather, the better explanation is that the new regulations reflect an increase in demand for regulation among the affected interest groups.⁷⁴ Any new insider trading rules will benefit these groups rather than the general public.

73. (1) S. 230, 100th Cong., 1st Sess. (1987), introduced by Senator D'Amato on January 6, 1987, entails proposed legislation that, *inter alia*, provides a definition of insider trading and holds companies civilly liable for money damages if the companies knew or should have known that their employees were engaging in illegal insider trading. For comment, see *D'Amato Proposes Insider Trading Bill with Definition of Insider Trading*, 19 Sec. Reg. & L. Rep. (BNA) 86 (Jan. 16, 1987); Boesky, *Other Insider Issues, Debated at Annual Securities Institute*, 19 Sec. Reg. & L. Rep. (BNA) 171 (Jan. 30, 1987). (2) S. 231, 100th Cong., 1st Sess. (1987), also introduced by Senator D'Amato, is an alternative to S. 230 and provides a broader approach to the insider trading problem. For comment, see *D'Amato Proposes Insider Trading Bill with Definition of Insider Trading, supra*. (3) S. 657, 100th Cong., 1st Sess., 133 CONG. REC. S2821 (daily ed. Mar. 6, 1987), introduced by Senator Metzenbaum, mandates treble damages for insider trading and provides a substantial increase to the civil liability penalties for insider trading (up to \$500,000 and up to five years in prison, or both). For comment, see *Metzenbaum to Propose Mandating Treble Damages for Insider Trading*, 19 Sec. Reg. & L. Rep. (BNA) 330 (Mar. 6, 1987). (4) H.R. 251, 100th Cong., 1st Sess. (1987), reintroduced by Representative Neal Smith (D-Iowa) on January 6, 1987, amends the Commodity Exchange Act, ch. 545, KK 1-13, 49 Stat. 1491 (codified as amended in scattered sections of 7 U.S.C.), to bar insider trading in the future industry and also defines "insider." For comment, see *Iowa Representative Reintroduces Bill Barring Insider Trading in Futures Industry*, 19 Sec. Reg. & L. Rep. (BNA) 139 (Jan. 23, 1987). (5) H.R. 1238, 100th Cong., 1st Sess. (1987), introduced on February 25, 1987, by Representative John Conyers (D-Mich.), Chairman of the House Judiciary Criminal Justice Subcommittee, mandates a ten-year jail sentence for criminal insider trading. For comment, see *House Bill To Increase Jail Term for Insider Trading Wins Mixed Reviews*, 19 Sec. Reg. & L. Rep. (BNA) 1091 (July 24, 1987). (6) H.R. 2494, 100th Cong., 1st Sess., 133 CONG. REC. H3908 (daily ed. May 21, 1987), introduced by Representative Frederick Boucher (D-Va.), permits the SEC to pay rewards for information leading to the detection and prosecution of unlawful insider trading and market manipulation. For comment, see *Boucher Bill Would Let the SEC Use Paid Informants to Fight Insider Trading*, 19 Sec. Reg. & L. Rep. (BNA) 782 (May 23, 1987). (7) S. 1323, 100th Cong., 1st Sess., 133 CONG. REC. S7601 (daily ed. June 4, 1987) (Tender Offer Disclosure and Fairness Act of 1987), introduced by Senator Riegle, along with Senator Proxmire, reforms the regulation of tender offers. The bill increases the maximum imprisonment for insider trading from five years to ten years and the maximum fine from \$100,000 to \$1 million. It also requires a minimum sentence of one year for perjury or obstruction of justice in connection with an insider trading investigation. See *Definition of Insider Trading (Part I): Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 2 (1987) (statement of Senator Donald W. Riegle) [hereinafter *June Senate Hearings*].

74. The following special interest groups are also active in this area of reform: (1) the Securities Industry Association (SIA) and their ad hoc group of industry officials formed to explore insider trading issues, see *SIA Forms Ad Hoc Group to Study Insider Trading Issues*, 19 Sec. Reg. & L. Rep. (BNA) 132 (Jan. 23, 1987), *SIA Urges Insider Trading Definition, Seeks More Surveillance by SRO's, Firms*, 19 Sec. Reg. & L. Rep. (BNA) 438 (Mar. 27, 1987); (2) the American Bar Association (ABA), see *ABA Members Call for Changes in Short-Swing Profit, Reporting Rules*, 19 Sec. Reg. & L. Rep. (BNA) 544 (Apr. 17, 1987); (3) the North

B. Public Choice and the Reregulation of Insider Trading

The judge-made law of insider trading created a strong demand among interest groups for increased regulation. The new clarity of the law greatly undermined the power of the Securities and Exchange Commission. Prior to the Supreme Court's decisions in *Chiarella* and *Dirks*, the vagueness of insider trading law created a strong demand for the SEC's services.

In particular, investment bankers and other market professionals who have large human capital investments in obtaining, assimilating, and reacting to corporate information that will affect stock prices, now can pursue leads and make trades without fear of unwittingly running afoul of the insider trading laws. The new clarity of the law allowed market professionals to engage in legitimate market research about undervalued firms free from fear of SEC sanctions. By contrast, the earlier confusion in the law had created a strong demand for the SEC's services because market professionals had to ensure that the SEC would decline to regulate their information processing activities. In other words:

From the SEC's perspective, the Court's decisions were problematic because they severely diminished the agency's power over its most important constituency, the investment banking community. . . . [T]he SEC's administrative control over these supplicants has diminished since the law is now on their side. The SEC would prefer a return to the days when the vagueness and incoherence of insider trading law provided the agency with a considerable source of power: . . . To the extent that the law remains vague, the SEC's services and regulatory forbearance are in demand.⁷⁵

Consistent with the public choice model, for years prior to the *Chiarella* and *Dirks* decisions, the SEC opposed the adoption of a precisely stated rule against insider trading. The SEC's opposition could stem only from a desire to retain the power to grant regulatory forbearance from the vague rules that existed before *Chiarella* and *Dirks*. Subsequent to those opinions, the SEC's position changed, and now the SEC strongly favors new insider trading legislation. The legislation the SEC favors, however, would not further the public interest. Rather, the SEC's proposed law is a "model of vagueness and obfuscation"⁷⁶ that is designed to permit the SEC to retain its plenary authority over its regulatory agenda.

The SEC has taken the position that any new definition of insider trading must be both sufficiently broad to include all activities that current

American Securities Administrators Association (NASAA), see *Speakers Offer Variety of Solutions for Insider Trading at NASAA Meeting*, 19 Sec. Reg. & L. Rep. (BNA) 555 (Apr. 17, 1987); and (4) the Securities and Exchange Commission (SEC), see *June Senate Hearings*, *supra* note 74, at 1009-41 (testimony of Charles C. Cox, Acting Chairman of Securities and Exchange Commission).

75. Macey, *supra* note 60, at 363-65.

76. *Id.* at 365.

case law prohibits, and flexible enough to permit the SEC to apply the definition to unspecified activities that the SEC has yet to define.⁷⁷ In sum, the SEC's efforts to change the judge-made law of insider trading is nothing other than "the SEC's concerted attempts to manipulate the insider trading rules to enhance its bureaucratic powers"⁷⁸ by reestablishing the SEC's administrative control over market participants.⁷⁹ Accordingly, the recent efforts by the SEC and its congressional allies to reregulate insider trading represent the SEC's attempt to reacquire the bureaucratic power lost when the Supreme Court at last established equitable, clearly defined rules against insider trading.

However, not only the SEC stood to lose from the Supreme Court's insider trading rulings. The incumbent management teams of corporations faced with the possibility of hostile takeovers also felt threatened by the *Chiarella* and *Dirks* decisions. The Supreme Court's decisions had improved the operation of the market for corporate takeovers by providing market professionals with greater incentives to engage in the costly process of searching for undervalued or poorly managed firms.⁸⁰ From the perspective of incumbent managers, therefore, the net effect of the Supreme Court's rulings on insider trading was negative because these rulings increased the probability that such managers would lose their jobs in a hostile takeover.⁸¹

In sum, the new impetus to reregulate insider trading does not arise from any new-found concern about the need for regulation in this area. In fact, a Wall Street Journal/NBC News poll found that the public was "ambivalent about what should be done" about the well-publicized insider trading scandals that the SEC's aggressive campaign against insider trading had uncovered.⁸² Rather, the new push for regulation is a result of organized interest groups that had been harmed by an exogenous shock to a pre-existing political equilibrium exerting political pressure on government officials. The exogenous shock came in the form of the Supreme Court's decisions in *Chiarella* and *Dirks*.

V. IDEOLOGY AND PUBLIC OPINION IN THE INTEREST GROUP MODEL

The above discussion demonstrates that the economic interests of organized interest groups are more reliable predictors of regulatory outcomes

77. See H.R. Doc. No. 355, 98th Cong., 2d Sess. 24-25 reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 2292, 2296-98 (Memorandum of SEC in Support of the Insider Trading Sanctions of 1984).

78. Macey, *supra* note 60, at 357.

79. *Id.* at 365, 372 ("Indefinite rules create a demand for the SEC's ability to engage in regulatory forbearance."); see Aranson, Gellhorn & Robinson, *A Theory of Legislative Delegation*, 68 CORNELL L. REV. 1, 33-34 (1982); see also Securities and Exchange Commission Proposed Insider Trading Bill (Nov. 18, 1987), reprinted in *SEC Compromise Proposal on Insider Trading Legislation; Accompanying Letter, and Analysis by Ad Hoc Legislation Committee*, 19 Sec. Reg. & L. Rep. (BNA) 1817, sec. 2, § 16A(b)(1) (Nov. 27, 1987).

80. Haddock & Macey, *Regulation on Demand: A Private Interest Model, With an Application to Insider Trading*, 30 J.L. & ECON. 311, 316-17 (1987); *supra* note 60, at 363.

81. Macey, *supra* note 60, at 363.

82. Ingersoll, *SEC, Despite its Hands-Off Stance on Takeovers, Pushes Regulation in Insider Trading, Other Areas*, Wall St. J., Apr. 24, 1987, at 52, col. 1.

than are public opinion and public ideology. But I wish to stress that ideology and public opinion play important, although frequently unappreciated roles in the public choice model. Unfortunately, in my view, ideology and public opinion generally enhance rather than suborn the selfish goals of special interests.

A. Ideology

People vote on ideological grounds and ideology can play an important role in determining political outcomes. Furthermore, people often vote on purely ideological grounds and sometimes even vote in ways that are plainly contrary to their private interests. But, as Professor Dwight Lee has pointed out in a recent and important article, such ideological behavior is consistent with, rather than antithetical to the economic theory of regulation.⁸³

The reason that citizens often vote for ideological reasons is simply that voting is an extremely inexpensive mechanism for self-expression and self-definition. Indeed, the vote itself costs nothing because "the probability [that] an individual's vote will be decisive in a typical election is effectively zero."⁸⁴ Voting in political elections, therefore, is a very low cost way for people to feel patriotic, and even self-righteous and altruistic. For example, wealthy individuals often give very little to charities, and still consistently vote for political candidates who favor systematic wealth transfers to the poor that will cost them money. The only explanation for this conduct is that these wealthy individuals realize that their votes, unlike actual donations to charity, cost them nothing because the votes will not affect the outcome of the issue.

People must derive some sort of utility from voting or else, given the low probability of affecting the outcome, it simply would not be possible to explain why anyone votes. Dwight Lee explains part of the phenomenon when he observes that

[p]eople are motivated to go to the polls and vote for the same reason that they are motivated to go to the sports arena and cheer. It is the satisfaction that comes from participation and expression, not the expectation that they will determine the outcome, that draws people to the polls and to the sports arena. There is no more difficulty reconciling voting with private interest than there is with reconciling attendance at sporting events with private interest.⁸⁵

Indeed, when one considers the fact that voting provides not only cheap entertainment, but a virtually costless vehicle for self-definition, for self-expression, and for signalling altruism, explaining voting behavior becomes easy. However, explaining why people vote for ideological reasons is not

83. Lee, *Politics, Ideology, and the Power of Public Choice*, 74 VA. L. REV. 191, 197 (1988).

84. *Id.* at 193.

85. *Id.*

the same thing as explaining the impact that such voting behavior has on actual policy. The answer is that voting behavior does not make much difference. Even where ideological expression in the voting booth determines a political outcome, the ultimate outcome that emerges from the legislative and regulatory processes will reflect interest group concerns. This is because, while the initial cost of ideological expression through voting is very low, the costs of overseeing the implementation of technically complicated statutes is extremely high. Interest groups completely dominate this aspect of the political process.

Take, for example, laws concerning environmental quality. Politicians may react to the ideological preferences of their constituents by campaigning on platforms that promise the passage of new and sweeping statutes to clean up the environment. But the costs to individual voters of (1) becoming informed about what sorts of environmental legislation would be best; (2) lobbying for the implementation of this legislation rather than a rival sort of legislation, and (3) monitoring those who implement the legislation even if it ultimately is enacted are extremely high.⁸⁶

Predictably, there is little genuine public surveillance of environmental protection programs, and organized groups have significant latitude to influence environmental programs in ways that serve their private interests. This means of course that these programs are far less effective at protecting the environment than they could be.⁸⁷

Thus, while the individuals who vote for legislation on ideological grounds will forget quickly about the legislation after it is enacted, "the affected organized interests will be unrelenting in their efforts to influence the day to day details of the legislation's implementation."⁸⁸ Moreover, the special interests' influence over the legislation undermines any apparent positive benefits of the ideological expression. For this reason even organized interest groups often appear to support laws that contain provisions that seem adverse to their interests.

B. *Public Opinion*

Public opinion, of course, is nothing other than the collective opinion of many individuals on a particular issue. Furthermore, public opinion can play as important a role as ideology in getting a politician elected or a statute enacted. But as described above in the case of ideology, once the public has expressed its opinion, the ability of organized special interest coalitions to take control of the process ensures that public opinion will play only an insignificant role in affecting the substance of political outcomes.

86. *Id.* at 196-97.

87. *Id.* at 197.

88. *Id.*

The most important distinction between ideology and public opinion is that public opinion is far more malleable at the hands of politicians than ideology. While public opinion is only opinion, ideology consists of ideas, principles, and beliefs.⁸⁹ As such, while the ideological convictions of individual voters are relatively stable, public opinion is quite unstable.

The stability of ideology can make things difficult for interest groups because interest groups sometimes find that laws or regulations they oppose, the public favors on ideological grounds. Interest groups may find it very costly for them to pass legislation that the public strongly opposes on ideological grounds. Where this is the case, an interest group's best strategy may be to join in the support of the legislation and then work to undermine its implementation. In addition, groups also can resort to passing vague or ambiguous statutes to side-step ideological opposition.

By contrast, interest groups often find it to be in their best interests to mount public relations campaigns to influence public opinion. By getting public opinion on their side, interest groups are able to obtain favorable legislation at a low cost. This is what public relations campaigns are designed to do. Just as interest groups can influence the opinions of lawmakers by controlling the flow of information they receive, so too can interest groups influence public opinion by controlling the public's *access* to information. Mobil Oil Company's remarkably successful campaign to influence public opinion in various ways, such as by taking out editorial advertisements in the New York Times and other major newspapers, is the best known example of this phenomenon.⁹⁰ The individual members of the public who are the recipients of this information do not have the resources or the inclination to engage in the research necessary to rebut the claims made by interest groups in the media or even to find out if there is another side to the argument.

In other words, rather than expend the resources necessary to obtain passage of a statute that runs counter to public opinion, interest groups often find it advantageous to expend the resources necessary to alter that opinion. Thus, it is not surprising that the SEC has attempted to create the clearly erroneous impression among the public that there will be a crisis in domestic capital markets unless strong action is taken to impose new

89. Macey, *Ethics, Economics, and Insider Trading: Ayn Rand Meets the Theory of the Firm*, 11 HARV. J.L. & PUB. POL'Y 785, 788-89 (1988).

90. See, e.g., *Quieting the Nerves*, N.Y. Times, Aug. 11, 1988, at A25, col. 4 (arguing that "government spending be cut to the bone," and against an oil import fee, an unreasonable increase on the federal tax on gasoline, and suggesting that, if new taxes are implemented they should be broad-based consumption taxes that do not tax "production and investment"); *Once More, Through the Looking Glass*, N.Y. Times, Aug. 25, 1988, at A27, col. 4 (arguing against allocation of interest expense provisions of 1986 tax law); *Truth, Fiction, and Solid Waste*, N.Y. Times, July 28, 1988, at A27, col. 4 (arguing that replacing petroleum-based products, such as plastic bags, with biodegradable products, such as paperbags, is not good solution to nation's solid waste disposal problems).

regulations on insider trading activities.⁹¹ Similarly, despite the real crisis in the banking industry, there have been no efforts to mold public opinion to favor tough new laws regulating the activities of banks, because it is not in the interests of the relevant interest groups to pay for such publicity. Thus, unlike ideology, public opinion, which special interest groups often can manipulate, can be an effective tool in the arsenal of such groups.

VI. CONCLUSION

This Article has presented an economic model of lawmaking in which legislative and regulatory outcomes are best explained as the result of a market dynamic in which rival interest groups compete for legal rules that will transfer wealth from less organized groups and from the general public to themselves. While ideology and public opinion have roles to play in this interest group dynamic, these roles ultimately are subservient to the dominant role of the competing special interest groups.

As the above examples from the financial services industry illustrate, it is inaccurate to say that we have entered a new era of increased demand for regulation as the result of any shifts in public opinion or voter ideology. Rather, to the extent that reregulation is in the offing, the demand for reregulation is because changes in current regulations' effect on organized special interest groups have led such groups to increase their demand for regulation. However, any reregulation that we observe is likely to take place alongside initiatives to deregulate other aspects of the economy.

Additionally, these legislative initiatives will have less to do with the public interest than with the narrower interests of special interest groups. Thus, in the realm of banking regulation, where apparently strong public interest arguments favor more regulation, we observe a major trend towards deregulation, while in the realm of insider trading, which had enjoyed the benefits of two brilliant Supreme Court opinions effectively clarifying the law, we observe a major trend towards regulation, not to clarify existing law, but to obfuscate it.

91. The fact is that many countries, including Japan, which has the world's most successful stock exchange, either have no rules against insider trading or no enforcement of such rules. Haddock & Macey, *Controlling Insider Trading in Europe and America: The Economics of the Politics*, in *LAW AND ECONOMICS AND THE ECONOMICS OF LEGAL REGULATION* 149 (J.M. Grafvon der Schulenburg & G. Skogh eds. 1986). Thus, the SEC's arguments that the public stands to be harmed unless tough new laws are implemented are clearly wrong.