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THE SEC AS A BUREAUCRACY: PUBLIC CHOICE, INSTITUTIONAL RHETORIC, AND THE PROCESS OF POLICY FORMULATION

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Policy-making at the Securities and Exchange Commission has been the subject of intellectual criticism almost since the agency's birth in 1934. By and large, this has come in two sequential waves. The first, marked by the scholarship of Louis Loss,[1] reflected lawyers' classical obsession with precision and coherence. This movement sought to rationalize doctrine with what its proponents saw as the underlying aims and objectives articulated in the legislative sources and other historical "first principles." It criticized the Commission's rule-making, interpretive pronouncements and enforcement programs when (but only when) there was perceptible disharmony.[2] This first wave thus accepted the basic aims of securities regulation largely as a given. By contrast, the second wave of criticism—initiated largely by economists like George Stigler and George Benston in the 1960s,[3] and only later gaining substantial acceptance among legal academics[4]—took direct issue with those aims. Challenging some of the most sacred assumptions of the law as administered by the SEC, such as the virtue of mandatory disclosure or the harmful nature of insider trading, this view claims that the Commission has substantially overregulated in areas such as disclosure policy, with excessive and paternalistic focus on

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1. This work continues today, in association with Loss' most prominent intellectual disciple, Joel Seligman. L. LOSS & J. SELIGMAN, SECURITIES REGULATION (3d ed. 1989). In many ways, this emphasis on historical coherence is a response to the rhythmic tendency of securities law to vary between periods of romantic frenzy, where doctrine is deemphasized, and doctrinal retrenchment. *See* Langevoort, *The Education of a Securities Lawyer* (book review), 80 NW. U.L. REV. 259, 260-61 (1985).

2. This phase's lawyer-dominated influence was felt most plainly in the SEC's own Special Study of the Securities Markets in the early 1960s, which sought to rationalize the regulatory system in light of market developments since 1934, especially the growth of the over-the-counter market. *See* Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966). And it almost led to much more. Drawing strength from the Special Study, the desire for coherence became the driving force behind the American Law Institute's restatement-like Federal Securities Code project in the 1970s.

3. *See* Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964); Benston, *Required Disclosure and the Stock Market: An Evaluation of th Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973).

4. Dean Henry Manne was one notable exception in the legal community during the earliest days as this wave built. *E.g.*, H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).

"investor protection" to the exclusion of more compelling notions of cost justification and allocative efficiency. This was an attack on the rationality of securities regulation. In the academic literature at least, the debate generated by this second wave of criticism dominates today.

To state concerns about either coherence or rationality, however, does not explain why it is that the Commission has behaved in a way that in substance has seemed to so many either incoherent or irrational. Only in the last decade has the literature even begun seriously to address this behavioral question. My aim in this essay, therefore, is to look at the SEC as a bureaucracy, to see if we can say something interesting about the process of policy formulation that, in turn, can aid in our understanding of the substance of securities regulation.

The behavioral explanation that recently has achieved the most currency draws from the body of literature on public choice theory, as articulated by such notable economists as George Stigler and Sam Peltzman.[5] Public choice theory posits that far from seeking any independent conception of the "public good," regulators simply and rationally seek to maximize their own level of external support, and thus frequently allocate wealth (in the form of regulatory subsidies and/or restraints on competition) to those groups that bid the highest in terms of such support. Often, this means regulation that actually favors some segment of the industry that the agency is supposed to control (sometimes referred to as the "capture" hypothesis), since that special interest is likely to be the best organized and most effective "rent-seeker."[6]

For instance, two economists who at one time served on the SEC staff, Susan M. Phillips and J. Richard Zecher, have applied public choice theory to the Commission's mandatory disclosure program.[7] In their view, published in 1981, the well-organized body of securities analysts and institutional investors had succeeded in gaining a more than $1 billion subsidy, with little compensating public benefit, by causing the Commission to require formatted data from issuers that would otherwise be elicited and pieced together at their own expense. Along the same public choice lines, David Haddock and Jonathan Macey have sought to explain both the failure of the SEC to pursue Congress' national market system goal with sufficient vigor,[8] as well as the prevailing system of insider trading

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5. *E.g.*, Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Peltzman, *Toward a More General Theory of Regulation*, 19 J. L. & ECON. 211 (1976).

6. There are other explanations for the capture hypothesis, of course. One is that agency staffs typically are at an informational and resource disadvantage vis-a-vis industry participants and are thus forced (perhaps reluctantly) to rely on those participants in the regulatory process. *See* Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667, 1685-86 (1975).

7. S. PHILLIPS & J. ZECHER, THE SEC AND THE PUBLIC INTEREST 21-23 (1981).

8. Macey & Haddock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315.

regulation.[9] And former SEC Chief Economist Gregg Jarrell has invoked it to explain the SEC-pressured movement away from fixed commission rates on the stock exchanges in the mid-1970s.[10] Note that nothing in public choice theory assumes that agency policy will constantly or rapidly shift in support of the moment's highest bidder. Rather, policy will usually reflect an accommodation or compromise among various competing interests (thus often being ambiguous and difficult to identify as special interest regulation), with the balance changing only slowly as the political equilibrium shifts over time. But the bottom line is always responsiveness to those external interests.

In the assumptions underlying its behavioral model, then, public choice theory posits hyper-rational agency action. That, of course, is where the theory's descriptive power may at first seem questionable in its application to the actions of administrative agencies, for there is both abundant anecdotal evidence and a vast body of research on organizational behavior that argues that the activity of bureaucracies is not characterized by a high degree of either sensitivity or responsiveness to external stimuli. Instead, typical behavior is more aptly described as inner-directed.

Classic works such as Anthony Downs' *Inside Bureaucracy*[11] maintain that large organizations will over time inevitably begin to displace stated goals with more self-serving institutional ones. Decisions made within the bureaucracy come to reflect a cognitive content that, in the words of one author who has studied the interplay between law and organization theory, is "the product of widely dispersed informational sources and diffused individual interests and attitudes, all mediated by structures, processes and chance in ways that defy translating or tracing the organizational decision into its individual sources."[12] Loss of control extends even (perhaps especially) to those who are supposed to be running the organization. Such diffusion of authority is the source of institutional biases that value conservatism, risk avoidance, "turf protection" and routine. Such behavior is especially pronounced in government agencies, which lack the discipline imposed by a competitive marketplace, and whose line personnel are protected from rapid replacement by civil service regulations.

While apparently in tension, the bureaucratic and public choice models are not incompatible. Relaxing some of the formal assumptions of the public choice model, one can posit intuitively that each decisionmaker within a bureaucracy will act as a utility-maximizer. Utility, in turn, can readily be understood in terms of that which serves as reward or compensation for certain behavior and runs the gamut from external "bribes" (e.g., promises of future employment in the private sector for key officials)

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9. Haddock & Macey, *Regulation on Demand: A Private Interest Model, With an Application to Insider Trading*, 30 J. L. & ECON. (1987).

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

11. A. DOWNS, INSIDE BUREAUCRACY (1967).

12. M. DAN-COHEN, RIGHTS, PERSONS, AND ORGANIZATIONS 34 (1986).

through ego gratification (e.g., favorable publicity) to institutional self-preservation or internal consumption (e.g., enlarged or preserved turf or budget, more leisure time for the staff)—even the sense of pride or satisfaction that comes from doing a task well. Most of these goals, however, are unobtainable except through cooperative group effort. One naturally would assume, therefore, that agency behavior would be primarily inner-directed—that is, explainable largely in terms of the difficult process of mediating among the conflicting interests of group members—until external stimuli change in a sufficiently compelling fashion so as to draw a critical mass of attention outward.[13] For precisely the reasons noted by public choice theorists, the diffuse and conflicting interests that exist on the outside as well will make significant change based principally on external perceptions a relatively infrequent occurrence. The deficiency in the public choice literature about the SEC has not been misdirection, therefore, but rather simply that it has not given proper emphasis to the internal transaction and agency costs that operate as a counterweight to the incentives to maximize institutional utility in external terms.

From this perspective of bureaucratic theory, for example, one tendency for which the SEC long has been criticized becomes perfectly predictable: risk aversion in the face of bounded rationality. It frequently is noted that agency staffs rarely are rewarded for successes such as the anticipation and prevention of a problem or the efficient balance of costs and benefits of a particular rule, but inevitably blamed for publicly observed failures within their jurisdictions. Vivid illustrations of the power of risk aversion are the Commission's experiences with such issues as the development of the national market system, the shelf-registration rule, and—more recently—the development of the institutional resale marketplace (proposed rule 144A). In each of these settings, the Commission backed off substantially from sensible and far reaching initiatives in the face of largely speculative arguments that such steps could have unfortunate consequences down the road—implicitly, consequences for which the SEC would be blamed. Here, of course, the interplay between internal and external stimuli is blurred; each of these decisions was very much the confluence of organized interest group pressure[14] and the institutional instinct for self-preservation.

This relates closely to another frequently observed property of bureaucratic behavior exhibited by the SEC: its disinclination to adopt or

13. In drawing the internal-external distinction, I do not wish to overstate it. Many forms of bureaucratic behavior serve both internal and external functions. For instance, favorable publicity both enhances external support and provides internal compensation. Steps taken with a view toward Congressional reaction are oriented both toward budget enlargement and ego gratification.

14. *See, e.g.*, *"PORTAL—A NASDAQ for Restricted Securities"* in H. Bloomenthal, ed., 12 Sec. & Fed. Corp. L. Rep., no. 2, at 100 (Feb. 1990) (describing "pocketbook" reaction of the exchanges and some investment banking firms in seeking a down-scaling of rule 144A).

endorse bright-line rules, notwithstanding the obvious value of such an approach in promoting planning and reducing the incidence of litigation. Inevitably claiming that such an approach provides a "blueprint for fraud," the Commission so often has seemed jealously intent on preserving the largest degree of discretion to penalize conduct that it determines, after the fact, to have been improper. One sees this in the Commission's historic preference for making policy through no-action letters or enforcement rather than through rule-making,[15] and in its niggardly approach to the development of safe harbor rules in areas (like the nonpublic offering exemption under the '33 Act) of considerable statutory ambiguity.[16] The flexibility that is preserved maximizes the effective scope of the Commission's jurisdiction and limits the opportunity for *post hoc* criticism based on the perception that, as a result of the particular line that it drew, the agency failed to prevent, if not encouraged, some activity that turned out to be socially harmful.

Another source of criticism that has often been articulated focuses on the dominance of lawyers in policymaking roles at the SEC. Along these lines, for example, Homer Kripke has argued that attorney domination has produced a regulatory "theology"—an impenetrable admixture of highly technical securities law and unwritten lore, accessible only to the experts inside and outside of the agency—that the Commission and its staff fervently seek to perpetuate.[17] Here, again, there is a predictable behavioral property. Regulators have a natural bias toward the presence (or enhancement) of complex regulation, rather than its absence (or reduction),[18] a function of institutional and personal self-esteem as well as economic self-interest. In many ways, this same bias is held by lawyers generally, and is hence reinforced when lawyers assume the function of regulators. One readily sees the legal mindset of the Commission's staff, for instance, in many of the immensely arcane and open-ended rules that achieve a good deal of technical elegance, if nothing else. And once more, this sort of behavior is likely to find at least one important source of external support. Indeed, the overwhelming number of SEC Commissioners and high level staff persons have been attorneys, and most have stayed at the Commission for only a few years before moving on or returning to private practice. Lawyers in private practice specializing in securities law—peers of the Commission's principal decisionmakers, as well (often enough) as their once and future employers—are direct beneficiaries of this mysterious theology. Whether one determines that this outcome is a function of bureaucratic goal displacement or is a straightforward application of

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15. *See* R. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA (1982).

16. *E.g.*, Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 70 (1989).

17. H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 4, 18-20 (1979).

18. A. DOWNS, *supra* note 11, calls this the "Law of Increasing Conserverism."

public choice theory, its likely effect on policy formulation cannot be understated.[19]

The fourth property of bureaucratic behavior, and the one on which I would like to focus the remainder of this essay is to me the most interesting. It is the tendency of any organization to adopt rhetorical conventions as operative norms in the ongoing policy-making process. Both common experience and bureaucratic theory teach that organizations will often develop attachments to rhetoric, which rhetoric then becomes increasingly influential in molding the later behavior of the agency.

Why? There are many reasons; one is that rhetoric operates as a signal to external constituencies and thus serves a political function. But it plays a more subtle internal role as well. To understand, it is necessary to consider the collective means by which policy is made at an agency such as the SEC. Depending on the type of media for its execution (enforcement action, rule-making, etc.), an initiative is likely to begin at the high staff level. This may be based on a signal from one or more of the Commissioners, perhaps not. Once initiated, however, the matter is moved downward to the staff group that will undertake the task of formulating the proposed action, drafting the proposal and writing the supporting memoranda. Once formulated, the draft moves through the supervisory layers for editing and revision.

Like many agencies, the SEC is not a discrete pyramidal hierarchy; rather, the various operating divisions (e.g., the General Counsel's Office, Enforcement, Corporate Finance) maintain coordinate responsibility for their various substantive jurisdictions. This means that some level of consensus among jurisdictions has to be achieved at the staff level, lest one oppose the proposal in front of the Commissioners and raise spectres about impact that are likely to provoke the risk-averse instinct of the five presidential appointees (who often have the lowest level of independent information about the project). And, of course, even at the Commission level, the presence of five separate persons who must come to a collegial decision in favor of the proposal itself creates another point requiring consensus-building.[20]

What we have, then, is a highly complex coordination problem: potentially scores of individual negotiations would have to occur to build consensus from a clean slate. This, of course, would be immensely time-

19. For an insightful analysis of the effect of lawyer influence on the development of Delaware corporation law, see Macey & Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

20. The creative role of the Commissioners is chilled by the Government in the Sunshine Act, which requires a formal meeting, public unless certain conditions are met, anytime more than two commissioners meet to discuss any policy-related issue. For a lament about the role of the Commissioner, see "Old Hands Guide the SEC Along," Nat'l L.J., Jan. 29, 1990, at 32, quoting former Commissioner Joseph Grundfest as wishing (jokingly) that he could be considered for a particular division director position so that he could have real responsibility in the agency.

consuming (and typically frustrating in a hierarchical setting because other sources of power have a fairly low cost ability to block a significant initiative). Here, it seems, is where rhetorical conventions gain their power. A person charged with formulating or reformulating the initiative is likely to mold the proposal based on rhetoric previously agreed to in earlier negotiations, if only to reduce both the risk and the transaction costs attendant to gaining each successive level of approval. In this way, each new initiative is influenced heavily by the *perception* of the past.

That last point is important, for it can actually enhance the power of the rhetorical convention over time. As new staff and Commissioners are introduced, their strategic behavior in molding initiatives *ex ante* so as to gain consensus is influenced not so much by first-hand experience in earlier negotiations but by some record of the historical result, typically the written rhetoric used to explain the result. That, of course, may well serve to overemphasize the rhetoric, but it is the best information available to the rational participant in the process. Moreover, once rhetorical conventions become established, their invocation (or incantation) becomes a means of demonstrating good faith commitment to institutional goals rather than some personal agenda, a key in any cooperative setting to increased influence over time. Conversely, refusal to invoke them operates as implicit criticism, instinctively a threat that may well lead to in-group exclusion.[21] Rhetoric, in other words, readily becomes theology, which in turn plays an important bonding role within the organization. Some staff will come to believe the conventions, others will simply assume them, and still others will accommodate them notwithstanding lingering skepticism. In this fashion, the expression of an idea comes to take on a life of its own, especially in an environment characterized (as with the SEC) by rapid turnover of key personnel.

What is the likely content of a rhetorical convention? A few generalizations seem commonsensical. First, such conventions will serve the interests of the widest possible audience within the organization. In this way, it is no surprise that the most powerful conventions will tend to reflect traditional bureaucratic tendencies: risk aversion over risk-taking, flexibility over precision, and conservation of jurisdiction over alienation. Where lawyers are involved heavily, those conventions will reflect what lawyers are taught to value: technical elegance, the power and dispassion of law, and the like. In this sense, of course, this property of bureaucratic behavior simply describes a mechanism by which some of the other properties described earlier become observable. Second, we may assume that external influences—the organized interests on which public choice theory concentrates—will operate on these conventions as they gain power, providing either sustenance or impediments to their continued influence.

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21. *Cf.* Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. & CONTEMP. PROBS. 83, 100-101 (1985) (describing in-group bias in the setting of corporate organizations).

Finally, there is no reason to believe that such conventions will always be valid or sound, especially as time goes on, or even internally consistent with other recognized conventions. The value of the rhetoric is functional, not necessarily substantive.

Stating this property in the abstract is far less illuminating than illustrating it in practice. Unfortunately, no outsider (and indeed, few insiders) are sufficiently privy to the entire policy formulation process to know what is convention rather than analysis in any particular instance. The best we can do is to look for situations where it appears that the Commission and staff collectively have begun to *assume* the truth of some assertion, rather than evaluating the issue *de novo* in connection with a specific policy initiative.

With this limitation in mind, I would like to search for some rhetorical conventions in an important setting of many of the Commission's deliberations today, the relative protection afforded by regulation to the individual investor vis-a-vis institutional or professional investors. We are all well aware of the gradual institutionalization of the securities markets. Technological developments, increasing economies of scale and governmental economic and social policies have all contributed to a domination of daily trading volume by institutions such as pension funds, mutual funds, insurance companies and bank trust departments, and—for many high capitalization stocks, at least—domination of actual ownership as well.[22] Potentially, this domination by itself may dampen individual investor interest in direct securities investment, by creating at least the perception that individuals cannot compete on an equal footing with the professionals, and thereby hasten the trend toward institutionalization. In a number of instances, the SEC has taken direct or indirect action that, ostensibly, is designed to limit the economic advantage of the institutional investor, in effect an implicit statement of concern about this trend.

Our first stop in the search for conventions is the very concept that often underlies such action: that individual investors are a necessary component of the securities marketplace because they "add depth and liquidity" to it. This notion is especially significant in today's deliberations over marketplace volatility.[23] Precisely what it means, however, is uncertain.[24] If one assumes that individuals who forego direct investment will simply channel their funds through an intermediary (rather than not invest at all), then the total dollar amount of investment will not change. Nor is there much evidence that the aggregate trading activity of individual

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22. An intriguing set of statistics is put forth in Brancato & Gaughan, "The Growth of Institutional Investors in the U.S. Capital Markets," a report prepared for the Institutional Investor Project of the Columbia University School of Law (Nov. 1988).

23. *See, e.g.*, Hazen, *Volatility and Market Inefficiency: A Commentary on the Effects of Options, Futures and Risk Arbitrage on the Stock Market*, 44 WASH. & LEE L. REV. 789 (1987).

24. *See* Branson, *Securities Regulation After Entering the Competitive Era: The Securities Industry, SEC Policy and the Individual Investor*, 75 NW. U.L. REV. 857 (1980).

investors has any significant long-term price impact; it is widely agreed that whatever efficiency properties the market possesses are largely the product of informed investor behavior, which are dominated primarily by the institutions. Admittedly, individuals are more dominant in some market subsets: in the over-the-counter market, and as purchasers in initial public offerings. In this sense, some of these issues might reasonably be characterized in redistributional terms—changing the relative balance may, in other words, affect the capital raising abilities of smaller companies vis-a-vis larger ones in some limited number of cases. But that is not the use to which this far broader rhetorical construct is put. So far as depth and liquidity is concerned, the point reduces to the highly suspicious assertion that a less informed or sophisticated segment of the market generally is desirable per se.

The conceptual usefulness and sensibility of this rhetorical convention is thus suspect, and one is left to wonder at its persistence. Its power as a convention, however, is easily understood by reference to bureaucratic behavior. Securities regulation as we know it is built on the very assumption of the presence of a large number of individual investors; a wholly institutionalized market would mean far less meaningful a role (and substantially less political power) for the SEC. Both institutional self-preservation and institutional self-esteem underlie these issues, then. And if this is indeed a rhetorical convention, it is likely to have the full support of a number of very important interest groups: the brokerage industry, which counts on individual trading for a fair portion of its profitability, and corporate managers, who benefit from a dispersed and disorganized shareholder class. These two needs, no doubt, come together to give the "depth and liquidity" assertion its force.

An important extension of this same convention is found in the analytical framework built by the Commission in its rulemaking regarding tender offers (and also, on occasion, its litigation program) under the Williams Act. The Williams Act itself has an ambiguous intent, designed largely to slow down the "Saturday Night Special" form of takeover bid, where short tendering deadlines and "first-come, first-served" rules might be thought to pressure shareholders into hasty and ill-informed decisions. Over time, however—and with only the slightest bits of support from the legislative history—the Commission has introduced into its policy formulation efforts a primary objective of egalitarianism. This objective holds that the average shareholder deserves at least the sense that he or she is on a level playing field with the arbitrage community, with some fair allocation of wealth between the two types of tendering target shareholders. This objective has been articulated, more or less explicitly, in a long series of policy initiatives, including the short- and hedged-tendering bars, the anti-warehousing rule for insider trading regulation under rule 14e-3, the "equal price" formulations of rules 14d-10[25] and 10b-13, and the more

25. Here we find the most explicit statement of the value of egalitarianism in takeover

recent proposal to deal with street sweeps. One can also see this close to the surface in the Commission's litigation and amicus program with respect to the definition of a tender offer, which has sought to turn many nonconventional bids (typically, purchases mainly from arb's or institutions) into public bids, thus granting individual shareholders rights of participation.[26]

Once again, close inspection renders this principle a curious one, not only for its relative lack of statutory support. Each of these rulemaking initiatives, by tying the hands of the arbitrageurs in some form or another, makes takeover bids somewhat more risky and difficult to accomplish, a result that intuitively would seem to deter some bidders from commencing bids in the first place. In this sense, there may well be a net loss to the average shareholder from this set of rules; at the very least, the issue is far more ambiguous than any of the Commission's rhetoric would ever acknowledge. On the other hand, this bias is again easy to understand in bureaucratic terms. And no doubt the various antitakeover interest groups are more than happy to offer external support to the continued existence of this particular rhetoric, if not some of the other conventions that the Commission has adopted in this field.[27]

One notable feature of rhetorical conventions is the lack of any necessary consistency among them. This can be illustrated by moving to a third setting where the SEC has adopted a rather clear posture in recent years, the treatment of investment analysts in the law of insider trading. In the aftermath of the Supreme Court's decision in *Dirks*,[28] it is well established that insiders (i.e., fiduciaries of the issuer) may not communicate inside information to others where the insider's intent is the pursuit of personal benefit. The negative implication is that business-motivated communications are immune from liability, and the Court clearly signalled that its purpose in articulating this standard was the protection of communications that are part of the information dissemination process, including information divulged in a non-self-serving way to investment

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regulation. *See* Exch. Act Rel. 22198, [1984-85] Fed. Sec. L. Rep. (CCH) ¶ 83,797 (July 22, 1985), at 87,559. For an intriguing study of the regulatory perspective, see Dennis, *This Little Piggy Went to Market: The Regulation of Risk Arbitrage After Boesky*, 52 ALB. L. REV. 841 (1988).

26. *E.g.*, SEC v. Carter Hawley Hale Stores Inc., 760 F.2d 945 (9th Cir. 1985) (rejecting SEC's view).

27. The Commission's view that the Williams Act reflects a Congressional intent to leave to the target shareholders the ultimate decision whether or not a bid should succeed seems to be another questionable rhetorical convention (see Johnson & Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862 (1989)), albeit another one that can reasonably be understood in terms of institutional self-esteem and turf preservation. This convention is used primarily in the Commission's effort to seek preemption of state "corporate law" takeover statutes that can operate to chill the entire takeover process, where heretofore the Commission has played a substantial role.

28. Dirks v. SEC, 463 U.S. 646 (1983). *See generally* D. LANGEVOORT, INSIDER TRADING REGULATION § 11.02[1] (1990 ed.

analysts. The theory behind this is that analyst activity is essential to the existence of the efficient market, seen as a substantial public good. In recent years, the Commission has embraced this view with a good deal of enthusiasm. Most notably, it went so far as to propose legislation in August 1987 that, among other things, would provide a safe harbor from insider trading liability for bona fide communications to analysts.[29] This posture is supported by a substantial body of literature from the academic community.[30]

At least when stated with such strength, this view is another curiosity. On its face, it seems inconsistent with the general fairness rationale of the insider trading prohibition generally, which demotes efficiency as the primary concern. In practice, it allows some level of communication to large, professionally informed investors that enables them to capture a trading advantage unavailable to the average investor—precisely the concern underlying the anti-tipping rule generally.

And on closer inspection, even greater ambiguity appears. First, it is by no means clear that *selective* dissemination will in fact have the desired efficiency effect: that depends on the ability of the market to identify particular analysts' clients as having some sort of informational advantage, and there is no reason to believe that that will typically be the case.[31] Second, there is a dissonance with the individual, rather than professional investor bias that pervades so much else of the Commission's rhetoric. The intellectual justification for protecting analysts is that the average investor who desires the advantage that comes from such access as the insider trading laws permit is free to purchase it[32]—typically, by investing in a professionally informed intermediary (e.g., a mutual fund). Yet this would be precisely the sort of consequence that the Commission has elsewhere sought to avoid. Finally, one must wonder whether a system that encouraged "business-purpose" dissemination of inside information to analysts that could be exploited by their clients would not result in issuers subtly selling access to inside information to analysts. While such sales might not be explicit, there is some possibility that access would be traded for analyst favor: a form of paid "touting" of the company's stock through public media. Nowhere has the Commission ever even addressed any of these questions; yet the virtue of the analyst has reached almost the level of idealization.

That suggests, once again, that the process of convention has taken hold, albeit one with less obvious explanation in terms of bureaucratic theory. In many ways it does seem to contradict the Commission's typical

29. Proposed § 16A(d)(4), reprinted in 19 Sec. Reg. & L. Rep. (BNA) 1284 (Aug. 14, 1987). The legislation did not pass either the Senate or the House.

30. *E.g.*, Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission*, 13 HOFSTRA L. REV. 127 (1984).

31. *See* Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 572-79 (1984) (insider trading generally).

32. *See* Fischel, *supra* note 30, at 145-46.

perception of institutional self-interest. Recall, however, that conventions exist largely because they are efficient; strategic behavior in a bureaucratic setting conforms to them on the assumption that their use will facilitate the process of policy formation. In the end, it may simply be that rational actors within the Commission have perceived that analysts are idealized by some critical mass of persons with policy-making responsibility at this particular point in time, and that no countervailing blocking tendency has surfaced among others. If so, we might suspect that this convention will have less staying power as personnel shifts over time. However, we should also note that external political support that tends to exist in favor of the natural consequence of any ideological adherence to the efficient market theory—i.e., deregulation—and the specific self-interest of both the business and professional investor communities in favor of the protected status of communications to investment analysts. Once again, internal and external explanatory forces seem to have coalesced in this area, at least temporarily.

The reference to the efficient market hypothesis deserves a further comment, for in some ways it also has begun to show some of the characteristics of a convention. In the last decade or so, the SEC has indeed indicated a willingness to make policy conform to the view that, at least for widely traded issuers, market prices do promptly reflect all publicly available information. The perception of bureaucratic endorsement has been sufficiently strong, in fact, that Judge Easterbrook was able to write in a recent opinion, without qualification, that "[t]he Securities and Exchange Commission believes that markets *correctly* value the securities of well-followed firms, so that new sales may rely on information that has been digested and expressed in the security's price."[33]

Whether this is an accurate statement of the Commission's view or not (it is probably itself something of a half-truth), it does illustrate the pervasiveness of this perspective in the law today. In part, this is for good reason. While some anomalies persist,[34] there is little doubt that the markets for widely followed stocks do exhibit a substantial degree of *informational* efficiency—that is, the ability promptly to assimilate the discovery of new data. And there are many reform initiatives in securities regulation that properly follow from acceptance of this hypothesis. There is apparently no such consensus, however, among economists on whether the markets are *allocatively* efficient, i.e., whether the resulting prices, though fully informed, bear a close relationship to the fundamental or intrinsic value of the issuer's securities. John Maynard Keynes, for example, was of the view that markets are often informationally but not

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33. Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 510 (7th Cir. 1989) (emphasis added).

34. *See* Wang, *Some Arguments That the Stock Market is Not Efficient*, 19 U.C. Davis L. Rev. 341 (1986); Gordon & Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. Rev. 761 (1985).

allocatively efficient,[35] and he has many influential modern adherents.[36] Yet this continuing debate within the economics community has had surprisingly little impact on a number of lawyers at and associated with the SEC, some of whom seem to have determined, for whatever political, professional or emotional reasons, that economists proved the efficient market hypothesis a decade ago and moved on to other topics entirely, so that all that is left is for the law to come into conformity with this intellectual orthodoxy. In legal circles, the rhetoric of the efficient market, too, may be taking on a life of its own.

CONCLUSION

The summary question arising from all of this is why it is important to focus attention on the SEC's rhetorical conventions. Besides the inevitable academic answer (because understanding is a virtue in and of itself), there seem to me two more discrete points.

First, understanding the process of policy formulation at an administrative agency says a good deal about the deference we ought to give to agencies in such matters as statutory interpretation. A familiar canon of construction holds that such deference is proper, on the assumption that the agency has the superior sensitivity and expertise that enables it to construe its underlying statute correctly, i.e., in a manner consonant with statutory intent.[37] Recent scholarship has offered plenty of reasons why this canon is inapt in any event.[38] The role of rhetorical conventions—which will appear readily in the agency's interpretation—suggests the additional reason that such interpretation may well tend to be the product of assumptions from the past rather than thoughtful deliberation in a contemporary setting.

The other is that identifying and acknowledging the presence of conventions can in the end be constructive—at least if external political forces are willing. Recall that conventions often reflect strategic behavior; calling assumptions into question publicly may make a particular participant less likely to believe that reference back to previous negotiations will in fact facilitate adoption of a new initiative. Internally, then, it may make sense for agencies such as the SEC to conduct periodic audits of assumptions (in the form of roundtable discussions, whether open or closed to the public) as an antidote to excessive habitual behavior. Scholars

35. J. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 156 (1936).

36. *E.g.*, Shiller, "Fashions, Fads, and Bubbles in Financial Markets," in J. Coffee, L. Lowenstein & S. Rose-Ackerman, eds., KNIGHTS, RAIDERS AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 56 (1988). From a legal perspective, see L. LOWENSTEIN, WHAT'S WRONG WITH WALL STREET (1988).

37. *E.g.*, Chevron U.S.A. Inc. v. Natural Resources Defense Council, 467 U.S. 837 (1984).

38. *E.g.*, Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 444-46 (1989).

and practitioners from outside can help prompt such reevaluations. While calls for reformation may often sound heretical, they are not always fruitless: sometimes, even in bureaucracies, theology comes to be seen as myth.