Self-Regulation in a Democratic Society

Richard A. Booth

Follow this and additional works at: https://scholar.smu.edu/jalc

Recommended Citation
https://scholar.smu.edu/jalc/vol50/iss4/4
"Self-regulation" sounds at first like self-contradiction. No doubt to many it is a concept more sinister than amusing. Whether it is employed by doctors, lawyers, accountants or securities and commodities firms, many will regard it with suspicion because it is not only blatantly elitist, but it is also subject to obvious abuse: what is to keep the self-regulated from setting up self-serving rules and giving themselves the benefit of the doubt every time someone complains? On the other hand, self-regulation suits the national temperament. Americans tend to be skeptical of regulations and authority. Generally, we prefer private action to government action, though we quickly become suspicious of private power too.\(^1\) Thus, if self-regulation is valid and workable, it is important to know why and how it works, not only to dispel our natural doubts but also because such a system may well be of wider use in a free enterprise economy, where so many decisions escape direct regulation.

The answers to the questions of why and how self-regulation works are not obvious. The best place to look for them, though, may be the securities industry. Self-regulation has been scrutinized more in this industry than any
other, perhaps because it was consciously imposed by acts of Congress in an admitted effort to turn the business into a "profession." Such a conversion, imposed from without, in a business so much in the public eye, and sporting so poor a reputation, provides a useful case study.

I. THE ORIGINS OF SELF-REGULATION IN THE SECURITIES INDUSTRY

Self-regulation in the securities business is most easily understood in connection with dealings in over-the-counter (OTC) stocks. The Securities Exchange Act of 1934 originally conferred upon the SEC the power to regulate OTC business practices directly. It was amended, however, in 1936 to require registration with the SEC of all broker-dealers and to provide for sanctions against a broker-dealer found guilty of any of several offenses. The 1936 amendment withdrew the Commission's power to establish any standards of practice, largely because the OTC business was poorly understood and totally unorganized.

It soon became apparent, however, that monitoring the performance of broker-dealers even once registered was more than the Commission could handle. Undoubtedly, too, the requirements of due process in disciplinary proceedings contributed to delays and added to the SEC's

---

2 The over-the-counter market differs from an exchange or auction market (such as the New York Stock Exchange) in that transactions typically occur between a customer and a broker-dealer acting as principal. Rather than relying on buyers and sellers to meet each other at a central place, in the OTC market a broker-dealer acts as a market maker and publishes the prices at which he will buy and sell a security. For stocks which are not frequently traded (of which there are many) there is no alternative to this type of market. For a more thorough description of the OTC market, see Poser, Restructuring the Stock Markets: A Critical Look at the SEC's National Market System, 56 N.Y.U. L. REV. 883, 894-96 (1982). See also Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970).


6 Jennings, supra note 4, at 947-48.

7 Id.
work load. Moreover, it must have been clear that the Commission, constrained by the necessity of specifying grounds for enforcement, did not have sufficient flexibility to prosecute new forms of fraud or to impose new business practices, and would therefore follow rather than lead the development of the industry. Yet, it must also have been apparent that the securities industry required some outside agency to establish goals for it. The problem was that government could not know what would work or, even if it did, force it upon an unwilling industry.

Thus, in 1938, Congress passed the Maloney Act, adding section 15A to the 1934 Act. The Maloney Act was conceived not as a means of imposing business practice regulation, but rather as a means of inducing those in the business to regulate themselves. Former SEC Chairman William O. Douglas explained the idea of self-regulation:

From the broad public viewpoint, such regulation can be far more effective [than direct regulation] . . . Self-regulation . . . can be pervasive and subtle in its conditioning influence over business practices and business morality.

---

6 This problem continues to plague the SEC to an extent. For example, the Commission has long desired to eradicate abusive "boiler rooms" (broker-dealers who use high pressure telephone sales tactics to sell one or a few low priced speculative issues) but has hesitated to outlaw such operations by a general rule. See Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961); Securities Exchange Act Release No. 13,195 (Jan. 21, 1977); Securities Exchange Act Release No. 20,943 (May 9, 1984) (proposing and reproposing a definiton of broker-dealer for purposes of Section 15 registration requirement). The apparent reason for the SEC's reluctance to promulgate a definite rule is that some securities are too risky for broker-dealers to handle profitably within the NASD's mark-up and underwriting discount guidelines. See, e.g., Alstead, Dempsey & Co., 16 SEC. REG. & L. REP. (BNA) 723 (Apr. 27, 1984); Norris & Hirshberg v. SEC, 177 F.2d 228 (D.C. Cir. 1949). One solution, of course, would be to rely on the SEC's discretion to prosecute only abusive boiler room operators, but the United States Supreme Court appears to take a dim view of that alternative. As the Court put it, "[w]ithout legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous. . . ." SEC v. Dirks, 463 U.S. 646 n.24 (1983). But see Silver v. New York Stock Exchange, 373 U.S. 341 (1963) (exchange could not prohibit members from dealing with non-member without according non-member minimal due process protections).


By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these large areas self-government, and self-government alone, can effectively reach. For these reasons such self-regulation is by far the preferable course from all viewpoints.\footnote{Address by SEC Chairman William O. Douglas, quoted in Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 L. & CONTEMP. PROBS. 663, 678 (1964).}

Essentially, the Maloney Act provides for the registration of an organization of broker-dealers as a “national securities association.”\footnote{15 U.S.C. § 78o-3(a) (1982).} In order to register, the Act requires that such an association have rules providing for the discipline of members and the promotion of just and equitable principles of trade.\footnote{Id. § 78o-3(b).} The Commission reserves the right to review, and even change, the rules proposed by the organization and to hear appeals from disciplinary orders.\footnote{Id. § 78s.} As an inducement to join the organization, the organization’s rules may provide that members can deal with non-members only at rates available to the general public.\footnote{Id. § 78o-3(e).} Thus, by being a member of such an organization one may receive certain discounts.\footnote{The ability to give and receive discounts is much more than a perquisite in the securities industry: as a practical matter new issues of securities could not otherwise be sold at fixed prices and secondary trading would be impaired by the customer’s having to seek out a market maker or pay an additional markup or commission to an introducing broker. *See supra* note 2; Securities Exchange Act Release No. 15,807 (May 9, 1979). Oddly enough the rule has proven somewhat difficult to enforce in connection with new issues because institutional investors have pressured broker-dealers to pass on some of the discount. *Id.*} The Act also suggests that the organization may engage in a limited amount of restraint of trade if it is appropriate to the furtherance of the goals of securities regulation.\footnote{15 U.S.C. §§ 78o-3(b)(6),(7) (1982). *See Silver v. New York Stock Exchange*, 373 U.S. 341 (1963); *Gordon v. New York Stock Exchange*, 422 U.S. 659 (1975).} The Ma-
loney Act states quite clearly, though, that such an organization must take its disciplinary role seriously or lose these potential benefits.\textsuperscript{18}

Only one organization, the National Association of Securities Dealers (NASD), has ever registered.\textsuperscript{19} In theory any number of organizations could have qualified, although it must have been apparent, even as the Act was passed, that potential benefits such as discounts and fixed fee schedules would be maximized if fewer organizations registered.

The result is thus not surprising, but the scheme can begin to look like a ruse. Viewed cynically, it is clear that Congress found in the Maloney Act a means of delegating its own regulatory authority, not to a government agency with commissioners ultimately accountable to the body politic, but rather to the industry itself. On its face the Maloney Act appears to give quasi-governmental authority to a self-selected and possibly self-perpetuating elite. If the affairs to be regulated are of legitimate interest to the government, one must ask how this delegation can be justified.

It is no answer that the NASD is subject to SEC supervision. The NASD has real authority, often exercised without interference from the SEC and sometimes used through disciplinary proceedings to deprive people of their livelihood.\textsuperscript{20} It may have been out of sensitivity to such arguments that at the time the Maloney Act was passed, the possibility of requiring broker-dealers to join was rejected. Indeed forced membership could have threatened the constitutionality of the scheme.\textsuperscript{21} As enacted, the Maloney Act would allow the SEC to argue that the organization was voluntary.\textsuperscript{22} Nevertheless, broker-

\begin{enumerate}
\item See 15 U.S.C. 78o-3(b) (1982).
\item Jennings, supra note 4, at 949-50.
\item See generally Jennings, supra note 4.
\item See id. at 949. The idea of mandatory membership was, however, resurrected and again rejected in 1964, apparently because of opposition from mutual funds whose dealers would have been required to join. Instead, the SEC was empow-
dealers were effectively threatened into joining the NASD: it was surely clear that failure to join meant regulation by the possibly stricter SEC. Still worse, once the SEC had been freed from supervising all broker-dealers it could concentrate precisely on those who had refused to join.

Although the Maloney Act was an innovation, it was not the first attempt to impose self-regulation. From the beginning the Exchange Act depended upon the stock exchanges to act as disciplinary agencies for their members. Perhaps because the exchanges already existed, had defined membership and were important forces in interstate commerce, it did not seem odd to grant them the equivalent of governmental authority, even if one regarded them as private clubs. Yet one's comfort with self-regulation is perhaps threatened by the realization that whether the organization or the authority comes first should make no difference. It seems more peculiar that an organization of immense national importance such as the New York Stock Exchange was ever unregulated, or was left to such a curious scheme of control as self-regulation appears to be.

While the constitutionality of self-regulation could be discussed at length, the objective here is to offer a theory that resolves the apparent contradiction between this particular form of self-regulation and notions of representative democracy.

---

25 For one answer, see J. K. Galbraith, The New Industrial State 119-20 (1967). Somewhat contrary to the view expressed here, Galbraith sees the economy as in fact regulated by the bureaucracy of business and thus advocates greater government intervention in the planning process.
II. SELF-REGULATION AND RULE DEVELOPMENT

Certainly the ends of the Maloney Act are quite laudable. As one court stated:

From the concept of cooperative (industry-government) regulation developed in the National Recovery Administration was born the organization of the [NASD] which, it was hoped, would provide . . . for the development and enforcement of high professional standards within the ranks of brokers and dealers . . . . Then Chairman of the SEC, William O. Douglas, outlined the twin objectives of [the] NASD . . . when he stated that [it] would bring about voluntary self-discipline in conformity to the law and would also encourage obedience to ethical standards beyond those which any law could establish. . . . Thus self-regulation was to encompass more than simple illegality. Guiding the broker-dealer to do that which is right and fair was to be as much a goal of cooperative self-regulation as was condemning that which is wrong and unfair. Rules, example, and professional banishment were to be used to attain the former, while the jailhouse was to be used to stamp out the latter.26

Undoubtedly it was hoped that the industry itself would impose more stringent rules than the SEC in an effort to keep the SEC away, and that enforcement methods largely freed from the strictures of due process would ferret out the worst offenders more quickly. At the very least, individuals might use a little self-restraint rather than risk detection. The risk, of course, was that of foxes guarding the chicken coop.

The actual result has been something in between. For example, in 1942 the SEC proposed that confirmations of OTC purchases state the best independent quotations for the stock available at the time of the transaction.27 The NASD opposed the rule, possibly because of the unrelia-

27 RATNER, Regulation of the Compensation of Securities Dealers, 55 CORNELL L. REV. 348, 370-74 (1970). See also R. JENNINGS & H. MARSH, SECURITIES REGULATION 579-80 (5th ed. 1982). Since these were "dealer" transactions with technically no agency relationship with the customer, there was no common law requirement
bility inherent in some quotations, the time required to thoroughly compare them, or because of a general reluctance to disclose markups to customers who may not have known they were paying a mark-up.28

In response, the NASD surveyed its members to determine typical mark-ups. Discovering that 71% of sales were made at a mark-up of 5% or less, the NASD issued an interpretation of its rules stating that any mark-up in excess of 5% would be regarded as unfair. The SEC was apparently satisfied and did not raise the matter again for twenty years.29

In 1962 the SEC proposed that all OTC transactions be performed on an agency basis unless the stock was already in a dealer’s inventory. Again, the idea was to force disclosure of mark-ups by turning them into commissions. This time the NASD responded that members would be forced out of dealing in OTC stocks because the New York Stock Exchange commission rate would be effectively imposed on all transactions. The SEC acquiesced, but by 1966 there had been a marked increase in agency transactions (from 50% to 66% of all OTC trades).30

Finally in 1978, the SEC amended its rules to require disclosure of mark-ups in any transaction in which a broker-dealer — acting as principal — himself went to market to fill a customer’s order, but it withdrew a proposed rule similar to the one proposed in 1942. The NASD this time around argued that the mark-up rule, the best execution rule and the public availability of quotations made the proposed rule unnecessary.31 Moreover, the NASD argued that the SEC’s rule would have been difficult to en-

---

28 Ratner, supra note 27, at 371.
29 Id. at 374.
30 Id. at 373.
31 The best execution rule requires a broker-dealer to obtain the best price available at the time. Execution of Retail Transactions in the Over-The Counter market, NASD Manual (CCH) ¶ 2151.03 (effective May 1, 1982) (interpretation of the NASD Board of Governors).
force and too expensive.\textsuperscript{32} Whether the latter is true (especially in an age of computers), the end result was to place enough information in the hands of the customer to allow a rough derivation of the information the SEC had desired to be disclosed.\textsuperscript{33}


\textsuperscript{33} Interestingly, Rule 10b-10 fails to require the disclosure of mark-ups in only one circumstance, \textit{viz.}, where the sale (or purchase) is made from (or to) the broker-dealer's inventory. Arguably, that is the only situation in which such information is material. See \textit{Chasins v. Smith, Barney & Co.,} 438 F.2d 1167 (2d Cir. 1970). \textit{See also R. Jennings & H. Marsh, supra note 27, at} 580-82 (questioning need for disclosure of market maker status). Very nearly all of the controversies that have arisen in connection with market regulation since 1934 can be characterized as involving the omnipresent conflict of interest generated by the fact that brokers and dealers are one in the same. As brokers they supposedly act as agent for the customer. As dealers they are themselves principals dealing with their customers. In 1934 Congress instructed the SEC to study the feasibility of separating the two functions (both in the OTC market and on the exchanges where specialist firms act as dealers and in effect make a market in stocks which are temporarily inactive). The Commission issued its report in 1936, concluding that this inherent conflict should be "managed" by the adoption of particularized rules regulating it. \textit{See SEC, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker} (1936).

This conclusion may well have been prompted by the recognition that securities of the smallest, newest, most speculative companies could not be marketed without some positive selling effort and that unless a unified broker-dealer was allowed to play both ends against the middle his return would not be sufficient to facilitate distribution and trading. Conceptually, this theory fits nicely with the delegation of substantive regulation of mark-ups to the NASD: in effect the choice was to allow the industry to exploit a regulated conflict of interest in exchange for holding down the return a broker-dealer could enjoy. The explanation may be extended to NASD supervision of discounts in connection with initial public offerings. \textit{See R. Jennings & H. Marsh, Securities Regulation} 512-22 (5th ed. 1982). The fact that this conflict was sanctioned also may have led to passage of the Investment Advisers Act of 1940, 15 U.S.C. § 806, and its relatively strict interpretation subsequently. \textit{See SEC v. Capital Gains Research Bureau,} 375 U.S. 180 (1963). Perhaps it was thought that since broker-dealers could not be elevated to investors' agents, some separate class of market professionals that could be so depended on should be created. This may also explain why the Investment Advisers Act prohibits purely performance-based compensation: allowing such compensation would attract higher-risk advisers motivated by contingent fees and possibly somewhat reluctant to advise clients to sell in order to avoid losses. There has recently been some discussion of allowing performance-based fees however. \textit{See 16 SEC. REG. & L. REP.} (BNA) (May 11, 1984) (reporting Investment Advisers Act Release No. 911, May 2, 1984, withdrawing proposed rule to allow performance-based compensation). Despite the Act and its interpretation, investment advisers also face considerable conflicts of interest. For one, they are generally very reluctant to advise that a particular stock be sold because they may be
In effect the SEC got everything except what it wanted. The industry, however, was privileged to choose its poison and could not have been heard to complain that government rules, established without regard to business realities, were interfering. It may have been that the SEC rule would not have worked as well. If an industry devised rule meets the need, implementation is bound to be easier, since those assigned the task have not lost face and have no incentive to find the faults of the scheme. Indeed, they have every incentive to make it work.

In the absence of self-regulation, an agency, simply in the course of doing its job, will raise issues again and again as the SEC did in 1942, 1962 and 1978. After all, the agency staff is paid to raise issues. A self-regulatory organization (with a counter-balancing instiitutional memory) can monitor such repetition, stave it off when too frequent, or revise its own rules to fit the repeatedly questioned practices. While it may be said that self-regulation is a way of avoiding regulation, one can also argue that any regulated industry needs an advocate to avoid the disruption of changing conventions too rapidly or more often than is consistent with its continued healthy functioning.

In the final analysis, perhaps the best test for the propriety of government regulation versus self-regulation is whether the matter in question may be handled by prescription as then SEC Chairman Douglas suggested. One possible way of identifying situations appropriate to self-regulation is by determining whether there is more than one acceptable outcome (as it appears there was with regard to dealer transactions). In such situations, insiders denied access to management or may lose underwriting business for their firm. Moreover, if the market is efficient investment advice is virtually worthless. Indeed evidence indicates that even the best advised investors (e.g., mutual funds) cannot consistently beat the market. See J. Lorie & M. Hamilton, The Stock Market: Theories and Evidence (1973); Note, Broker Investment Recommendations and the Efficient Capital Market Hypothesis: A Proposed Cautionary Legend, 29 Stan. L. Rev. 1077 (1977).

* See supra note 11 and accompanying text.
may be better able to choose among alternative solutions.\textsuperscript{35}

III. Civil Liability and Self-Regulation

One of the most important issues regarding self-regulation is whether a customer can sue for a violation of an industry-imposed rule. The answer greatly affects public perception and pressure for greater outside regulation. If one cannot sue, the public is likely to think self-regulation is mere window dressing: an effort to create the aura of professionalism and with it, ironically, immunity from responsibility.

If suit is allowed, however, the profession itself will be reluctant to set high standards. Moreover, the threat of legal action may encourage excessively precise standards in order to make technical compliance easier. Innovation may be discouraged because even an experimental change in rules or alteration of business practice might be perceived as reflecting accepted practice. In short, raising self-regulation to the level of law, rather than recognizing

\textsuperscript{35} The distinction is analogous to the rationale behind the business judgment rule in corporation law. See Booth, The Business Purpose Doctrine and the Limits of Equal Treatment in Corporation Law, 38 Sw. L.J. 853, 877-79 (1984). One may think of the NASD as itself in the business (or meta-business) of developing and improving systems of non-exchange trading rather than as a cartel of broker-dealers, and it would not be surprising to find that other industries in which inter-firm dealings and conventions are particularly important have similarly strong self-regulatory organizations ("SROs") or could benefit from the cost savings an SRO could achieve.

Regarding the notion that the NASD is a meta-business, there is substantial evidence that it competes vigorously with the exchanges for listing. See, e.g., SEC Approves NASD Proposal to Expand National Trading System for OTC Stocks, 16 Sec. Reg. & L. Rep. (BNA) 1828 (Nov. 23, 1984). Such competition is nowhere more evident than in connection with the ongoing development of the National Market System. See R. Sobel, Inside Wall Street 67, 115 (1977); Seligman, The Future of the National Market System, 10 J. Corp. L. 79 (1984); Poser, Restructuring the Stock Markets: A Critical Look at the SEC's National Market System, 56 N.Y.U. L. Rev. 883 (1982); Werner, Adventure in Social Control of Finance: The National Market System for Securities, 75 Colum. L. Rev. 1233 (1975); Competition with the exchanges, in addition to supervision by the SEC, may be quite effective in keeping the NASD honest. On the other hand, competition with the exchanges probably does not temper the authority of the NASD as exercised against the smallest broker-dealers.
its unique value, encourages setting a minimum standard of behavior rather than expressing a goal or a possibly unattainable maximum.\textsuperscript{36}

The issue whether to allow private law suits for violations of the rules of a self-regulatory organization ("SRO") is quite alive in the securities industry. It often arises in connection with the NASD's "suitability rule," which requires that a recommendation regarding a security bear some relationship to the needs of the customer.\textsuperscript{37} The rule is not supposed to be insurance against errors in judgment, but rather is meant as a representation, based on the expertise of the broker-dealer, that there is something more to a recommended stock than the commission he will receive.\textsuperscript{38}

Given the quasi-legal status of the NASD, it is not surprising that a customer whose investment has turned sour will argue it was "unsuitable" and will cite the rule. Few courts have allowed recovery on this basis alone.\textsuperscript{39} How-


\textsuperscript{37} NASD, Rules of Fair Practice Art. III, § 2 provides:

In recommending to a customer the purchase, sale or exchange of any security a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

A similar rule stated in the negative was adopted under the SECO system. The NYSE "Know Your Customer" Rule (Rule 405) is similar but arguably broader. See Buttrey v. Merrill Lynch Pierce Fenner & Smith, Inc., 410 F.2d 135, 141 (7th Cir. 1969)); see also Lange v. Hentz & Co., 418 F.Supp. 1376, 1381 (N.D. Tex. 1976) (NASD rules are designed primarily to protect NASD members and only incidentally protect customers).

\textsuperscript{38} Mundheim, Professional Responsibilities of Broker-Dealers: The Suitability Doctrine, 1965 DUKE L.J. 445, 448. The suitability rule (focusing on the characteristics of the investor) works in tandem with the reasonable basis requirement (focusing on characteristics of the investment). See infra notes 50-53 and accompanying text. See also Bines, Setting Investment Objectives: The Suitability Doctrine Pts. 1 & 2, 4 SEC. REG. L.J. 276, 418 (1976).

ever, in the words of one state court:

It may be asserted that the proposed guidelines are merely ethical standards and should not be a predicate for civil liability. Good ethics should not be ignored by the law. It would be inconsistent to suggest that a person should be defrocked as a member of his calling, and yet not be liable for the injury which resulted from his acts or omissions.40

Does a civil remedy so clearly follow from the possibility of "defrocking"? Not necessarily. While a civil remedy may make the customer whole, in the long run the judicial definition of "suitable" would be so elusive as either to be hollow or an absolute guaranty against declining stock prices. On the other hand, disciplinary proceedings are a genuine sanction. The remedy and indeed the proceeding itself are sufficiently drastic to create a substantial incentive for self-restraint. Indeed, disciplinary proceedings tend to occur somewhat unpredictably and tend to generate more circumspect behavior on the part of the SRO members.41

Moreover, a court of law must strain to devise an appropriate remedy which encourages self-restraint but does not invite excessive litigation. Courts may well be incapable of reaching such a balance. For example, in Miley v. Oppenheimer & Co.42 the court, in allowing recovery in a "churning" (excessive trading) case, recognized that mere

Hammill & Co., [1974-75] Fed. Sec. L. Rep. (CCH) ¶ 95,021 at 97,582 (S.D.N.Y. 1975). In each of these cases the court has noted among other things that SRO rules may be viewed other than as intended primarily for the benefit of investors which is, of course, a vital factor in the test for whether a private right of action exists. See Cort v. Ash, 422 U.S. 66 (1975); Touche Ross & Co. v. Reddington, 442 U.S. 560 (1979); Transamerica Mortgage Advisers, Inc. v. Lewis, 444 U.S. 11 (1979).

40 Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690; 69 Cal. Rptr. 222, 244 (1968).

41 See Calfee & Craswell, Some Effects of Uncertainty on Compliance with Legal Standards, 70 Va. L. Rev. 965 (1984). Although Justice Holmes said, "[T]he very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it . . . ", Superior Oil Co. v. Mississippi, 280 U.S. 390, 395-96 (1930), this hardly seems to be the case regarding SRO rules and disciplinary proceedings.

42 637 F.2d 318 (5th Cir. 1981).
disgorgement of commissions by the broker-dealer would not discourage repetition. Thus, the court awarded the plaintiff three times the commission that had been paid in connection with the unnecessary trading.\textsuperscript{43} Such a remedy, however, may unduly encourage disappointed investors to sue. Even if one subscribes to the philosophy that the securities laws were intended to protect investors, presumably investors are still expected to bear the risk that they will lose money.\textsuperscript{44}

By refusing to allow a civil remedy the courts preserve the ability of self-regulators to set higher standards. A notable example is \textit{Ernst \& Ernst v. Hochfelder},\textsuperscript{45} a case which arose from the negligent failure of an accounting firm to discover a mail opening practice which allowed the president of a securities firm to embezzle certain customers’ funds. The plaintiff argued that if the auditors had abided by appropriate auditing procedures as set forth by the profession they would have discovered the fraud. The Supreme Court refused to recognize a cause of action based on the auditors’ negligent failure to comply with the profession’s established auditing procedures.\textsuperscript{46}

Although it may be argued that accountants play a central role in the scheme of federal securities regulation and that investors are encouraged to rely on them, \textit{Hochfelder} has a very sound basis in policy. Accounting rules are very much like the common law: although codifications exist, it is generally agreed that the standard is what the profession does. The profession does not undertake to insure that every similar situation will be similarly treated. Rather, practice is expected to vary somewhat as auditors improve their craft. Indeed, the SEC, though apparently empowered to promulgate its own accounting rules, has declined to act directly and has instead typically suggested

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{43} \textit{Id.} at 332.
  \item \textsuperscript{44} \textit{See Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).}
  \item \textsuperscript{45} 425 U.S. 185 (1976).
  \item \textsuperscript{46} \textit{Id.} at 206.
\end{itemize}
\end{footnotesize}
improvements to the profession. The substance of this approach is well illustrated by an SEC release in which the Commission purported to establish a policy that it would regard as authoritative only those standards promulgated by the profession’s self-appointed Financial Accounting Standards Board:

It should be noted that Rule 203 of the Rules of Conduct of the Code of Ethics of the AICPA [American Institute of Certified Public Accountants] provides that it is necessary to depart from accounting principles promulgated by the body designated by the Council of the AICPA if, due to unusual circumstances, failure to do so would result in misleading financial statements. In such a case, the use of other principles may be accepted or required by the Commission. This directive is roughly equivalent to saying “follow the rules unless in your judgment it is better not to.”

As with the securities business itself, the SEC seems to regard detailed rules imposed from without as less effective than the self-control that can be induced by the threat of intervention. Although the SEC argued for the losing side in Hochfelder, had the Hochfelder decision been otherwise, its greatest impact might well have been to restrain the innovative quality of standard setting among self-regulated professionals, including broker-dealers.

---


49 It is frequently said that the goal of the federal securities laws is the protection of investors. While this idea may seem banal it is not even necessarily true. One need only read Section 1 of the Securities Exchange Act to see that Congress was at least concerned about the health of the capital markets. Indeed it might be argued that Congress’ concern with investor protection was derived from its concern with capital formation. The SEC has recently become much more conscious of the latter. See M. Steinberg, Corporate Internal Affairs 44-49 (1983) (discussing, generally with disapproval, new rules regarding smaller offerings and shelf registration). A similar dispute exists in antitrust law. The obvious rationale for the antitrust laws is consumer protection, but it also has been argued that
IV. TARGETS AND REMEDIES

Often it seems that the burdens accompanying the development of self-regulation fall disproportionately on the little guy. Some of the most important principles governing broker-dealers have been established in administrative proceedings brought against small firms, while larger firms tend to be treated more lightly when they are sued, if ever. On occasion this has sparked heated debate within the SEC. While a bigger firm may be excused because its officers are less able to know, from one office to the next, of possible violations by its employees, the bigger firm can also be expected to undertake a bigger compliance effort appropriate in size and sophistication to the firm. Again it is possible to view this apparent bias against smaller firms quite cynically: the big firms run the self-regulatory organizations and protect themselves first before seeking to upgrade the industry.

Of course, there is always the threat of direct government intervention to keep such behavior in check. Nevertheless, the SEC must ultimately avoid being too harsh with the powerful firms. The stock market is a centerpiece of the economy. Its health and smooth functioning reflects and in turn induces health (or illness) in the economy. Much of the nation’s wealth is held in the form of stocks and other types of instruments negotiated through securities firms. Thus, the machine must continue to run even while being repaired.

antitrust is legitimately intended to confine the exercise of private economic power when it might challenge the ultimate authority of government. See Bork, Bowman, Blake & Jones, The Goals of Antitrust: A Dialogue on Policy, 65 COLUM. L. REV. 363, 377, 401, 422 (1965). In short, in both areas, the law is legitimately concerned with the structure of institutions. As is suggested below, however, see text accompanying note 47, government is more than defensive. It may well be vital for economic growth for government to formulate general goals.


The SEC seems to have realized over the years that its own essential mission — disclosure of useful information to investors — depends on the brokerage industry as its primary vehicle. Unless practices in the industry foster informing investors, few of those carefully crafted periodic reports or press releases will ever come to the attention of their intended audience. The process started with the notion that a broker-dealer who hangs out his "shingle" holds himself out as having expertise and that he implicitly warrants that the price he charges for a security is close to the market price. Thus, the SEC built what is known as the "shingle theory."\(^5\)\(^2\) Broker-dealers were also found to have acquired fiduciary status by reason of their customers' reliance on them.\(^5\)\(^3\) Having thus built a "profession" out of whole cloth, the Commission proceeded to use it to impose a variety of further duties. Securities firms must gather information about companies whose stock they recommend and about companies for whom the broker-dealer makes a market but which do not file periodic reports under the Exchange Act.\(^5\)\(^4\) There are even cases which arguably stand for the proposition that a broker-dealer has a duty to keep his customers informed after an otherwise unobjectionable sale.\(^5\)\(^5\)

\(^5\)\(^2\) See Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943). When I first heard of the shingle theory while working on an NASD proceeding brought against a client, I surmised that the phrase related to the curious overlap of disciplinary functions in the securities industry much like shingles on a roof. While I found this image helpful, I soon discovered the phrase actually referred to a broker-dealer's "hanging out his shingle" as other professions are said to do. In retrospect I should have realized that nothing quite so colorful as my image was likely to emanate from the legal mind.

\(^5\)\(^3\) See Norris & Hirshberg v. SEC, 177 F.2d 228 (D.C. Cir. 1949).


\(^5\)\(^5\) See Merrill, Lynch, Pierce, Fenner & Smith, Inc., Securities Exchange Act Release No. 14, 149 (1977). A recent attempt to extend the theory may be seen in Dirks v. SEC, 681 F.2d 824, 840-42 (D.C. Cir. 1982), rev'd, 463 U.S. 646 (1983) where Judge Wright held that an analyst employed by a broker-dealer acquired a fiduciary duty by virtue of his profession and that, notwithstanding the fact that he had acquired non-public information through legitimate investigation, he could be held liable under Rule 10b-5 for failure to disclose the information prior to
None of these improvements in the information system would have been possible unless the industry was self-regulating, because it is unlikely that a directly regulated industry could have been forced to do what the securities industry at least has come to recognize as a responsibility. Moreover, rules explaining the duty could not have been devised with sufficient clarity to guide ministerials, or would have been too vague to withstand legal attack. In short, the SEC could not do directly what it does indirectly.

Unless we are willing to contemplate dismantling the securities industry, it must be admitted that any improvement in the financial markets depends directly on the private institutions which compose them and which must manage the changes. Ultimately, however, we may view the use of smaller firms as legal guinea pigs as unfair. After all, careers are destroyed in the process. It is important to keep some perspective, however. If the financial markets are to be improved and if we are to pursue a policy of growth, alterations in the pattern of doing business must be expected. With alterations, particularly those forced by legal means, someone whose business depended on the newly prohibited activities will suffer. Though we do not often think about it, the common law has always embraced the harsh truth that the first person to commit an illegal act often will have no way of knowing in advance that his actions were illegal.

Of course all of this could have been different. At some point the SEC seems to have decided that broker-dealers, whose business was roughly evenly divided between agency and principal transactions, should be agents first, and principals only when unavoidable. The SEC could have decided oppositely and proceeded to eradicate any impression that broker-dealers were agents in their cus-

advising his customers to trade on the basis of it. The Supreme Court dismissed the theory as novel and not raised by the plaintiff SEC. 103 S.Ct. at 3255.

customers' minds. In reality, the customers probably had no expectation one way or the other since they never knew at the time of placing an order whether it would be executed by the firm as broker or as dealer.

One might also object that the entire process of "professionalization" was beyond the authority of the SEC, which was charged with perfecting disclosure.\(^5\) However, the Exchange Act quite clearly speaks to the health of the markets generally, and, in practice, even absent that statutory support, disclosure cannot be effected except through customers' most frequent contact — broker-dealers.\(^5\)

V. LEGALISM AND ECONOMIC GROWTH

This suggests one final point. Innovation in the securities industry has clearly depended upon the SEC's formulation of goals and the industry's implementation efforts. In an industry so competitive, in which the innovation itself relates to business conventions, one may surmise that both are necessary parties. This implies not only a responsibility on the part of the SEC but also a responsibility on the part of the industry to exercises its self-regulatory privilege in light of this ultimate justification. Currently the entire scheme is being tested once again in the development of the National Market System. The project is going slowly (and some say being obstructed by the industry). The ability of the SEC to lead a positive


\(^5\) It is entirely possible that the idea of turning the securities business into a profession was born of a combination of New Deal moralism and a calculated risk to confer a modicum of monopoly power on the business (to "fatten it up") in exchange for the business agreeing to conduct itself in a less risky fashion. Nevertheless, in hindsight it appears that there is an additional public benefit: the enhancement of the reputation of broker-dealers has worked in tandem with mandated disclosure to reduce the costs of information for investors, and thus to make the markets more efficient and less risky than before. See Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 613-21, 635-42 (1984). Cf. Lange v. H. Hentz & Co., 418 F. Supp 1376 (N.D. Tex. 1976) (NASD rule is primarily intended for the benefit of NASD members).
project such as this, as opposed to pursuing an enforce-
ment function, has been questioned. Still it is difficult to
see an alternative mode of managing change. Of course,
it is always frustrating to await results when it appears
that it is merely necessary to choose one consistent sys-

tem. It must be kept in mind, however, that there may be
many such systems, and the abilities of both the SEC and
the industry are limited. The SEC is not in a position to
know what will work in practice. The industry is not capa-
ble of predicting what the SEC will find objectionable.
The task is therefore necessarily accomplished a step at a
time.

It is conceivable that one day the market will have been
perfected. Then attitudes and expectations should
change. It will be possible to establish rules with preci-
sion, and people in the industry will be entitled to security
in exchange for compliance. But it is crucial to remember
the inconsistency between that sort of predictability and
any sort of innovation. To put the matter as starkly as
possible: legalism is inconsistent with growth.

This inconsistency is not peculiar to the securities in-
dustry. Though it may sound odd to speak of manufactur-
ers, for example, as self-regulated, clearly those who
decide what goods are to be produced make an important
public decision. Nearly all the productive assets of the
country are in private hands. While the owners may be
prohibited for a good reason from putting them to any
particular use, they cannot be forced to invent new or bet-
ter uses. What a new or better use is cannot fully be de-
scribed to them, and there is no way to put the matter up
to a vote. Indeed the most notable occasion on which a
manufacturer attempted to derive a new product from in-
formation collected about the desires of consumers, the
Edsel episode, was a disaster which seriously weakened
the Ford Motor Company, one of the nation's important
assets. More recently, the National Science Foundation

---

59 Poser, supra note 2, at 946-51.
60 For a thorough investigation of the Edsel fiasco from this perspective, see
revealed that it had no means of determining which applicants for grants were most worthy. Instances such as these caution against the belief that formulas, the scientific method, or precisely crafted legal rules may be used to derive hitherto unknown improvements in any system.

Although business in general has toyed with the notion of professionalism, there is far from any consensus in favor of it. Yet, there is no question that business is self-regulated. In the case of the Edsel some recognition of the attendant responsibility would have helped.

Therein lies the essential point of this essay. To the extent we desire improvement and economic growth, the law must be restrained: innovation cannot itself be manufactured by the interplay of rules — at least not yet. If

Deutsch, Selling the People's Cadillac: The Edsel and Corporate Social Responsibility (1976); see also Chazen, Greening the Grey Flannel Suit, 86 Yale L.J. 185 (1976) (review of Deutsch).

61 N.Y. Times, Nov. 13, 1981, at 1, col. 6 (study supervised by National Academy of Sciences concludes that luck plays as big a role as merit in determining which scientists get research grants from the National Science Foundation).

62 In short, no rule can apply itself. See Kuhn, The Structure of Scientific Revolutions (1962); Wittgenstein, I Philosophical Investigations (1953). See also Hutchinson, From Cultural Constructions to Historical Deconstruction, 94 Yale L.J. 209 (1984) (review of White, When Words Lose Their Meaning: Constitution and Reconstitutions of Language, Character and Community (1984)).


64 Though the proposition is not uncontroversial, it is generally agreed that economic growth is desirable. See generally, P. Samuelson, Economics 742-65 (11th ed. 1980). Ultimately one's opinion of self-regulation is dictated by one's belief about the nature of the human behavior and the human mind. If one believes that human behavior can be reduced to the predictable interplay of rules — as the behaviorists, for example, seem to believe — then one probably would find self-regulation to be somewhat offensive since, at least in theory, the SEC, given enough time, energy and information could engineer the ideal set of rules. See, e.g., J.K. Galbraith, The New Industrial State (1967); J. Habermas, Toward a Rational Society (1968); J. Habermas, Knowledge and Human Interests (1968). The behaviorist thesis that human behavior can ultimately be explained through the scientific method, is a view that has also been associated with Marxism.

If one is not a behaviorist, and instead subscribes, for example, to Gestalt psychology or phenomenology, one is likely to believe in the wisdom of self-regulation since within such schools of thought perceptions of events are thought to be
one accepts the theory of self-regulation offered here, it becomes clear that the self-regulated exercise a privilege in exchange for taking on a duty. Awareness of that fact should itself contribute to both self-restraint and the appropriate use of disciplinary actions. In short, we need not despair of all possibility of control. Self-regulation is one way innovation may be indirectly regulated without being destroyed.

CONCLUSION

In the end self-regulation is neither self-contradictory nor inconsistent with democratic principles. Quite to the contrary, it complements democracy very nicely in that political stability depends greatly on economic growth. Nevertheless, self-regulation will always be viewed with some suspicion unless we are willing to admit that, even in theory, a government of laws cannot do everything.

unique from person to person. Thus, values and individual interpretations of events are regarded as genuinely important. See, e.g., W. Kohler, The Place of Value in a World of Facts (1938). The problem with this view is that it tends to be solipsistic: it suggests that it is not possible to know whether other people think as one does oneself.

There is a middle ground however. This school holds that rules do dictate behavior but that the rules can change (and indeed can change themselves). Such thinking is central to work being done in artificial intelligence. See D. Hofstadter, Godel, Escher, Bach: An Eternal Golden Braid (1979). This school may well be traceable to Kant. See H. Arendt, The Life of the Mind (1978).

In essence, this school of thought suggests that knowledge is very much like a theory. If the theory explains enough one treats it as true; when it begins to falter one develops a new theory. On balance such a philosophy of mind and behavior leaves considerable room for self-regulation: while it assumes that in normal times consensus is often possible, it also leaves room for continuous experimentation with new theories. Indeed, in a sense it requires such experimentation. In any case, theorizing remains indeterminate and as such is best left to those closest to the activity in question.