Transcript of Remarks of Richard B. Smith, Commissioner of the Securities and Exchange Commission, before National Institute Program of the American Bar Association (Section of Administrative Law), Panel on Impact of Ash Council Recommendations, Washington, D.C. April 16, 1971

MODERATOR WOZENCRAFT: But we do need to hear from one of those people who would be abolished by the Ash Commission Report, and one who is a member of the Securities and Exchange Commission. He is a Republican appointee of a Democratic President, a distinguished lawyer in the securities and C.A.B. field before he came to the Commission, and a gentlemen who recently completed the Institutional Investor Study, Commissioner Richard B. Smith.

(Applause.)

COMMISSIONER SMITH: Thank you, Frank.

I have come from (mistakenly) "Chairman" at the luncheon, to (accurately) Commissioner on the program, to (fatefully) "expendable" in Frank's introduction, all in the space of about three hours!

(Laughter.)

I believe a comment was made in Parliament during the British constitutional crisis in the mid-thirties when the King was determined to marry a Commoner divorcee. Feelings were running high in England then.

"Oh, my lords, how great a fall from High Lord of the British Admiralty to third mate of a Baltimore tramp."

I know something of the feeling!

(Laughter.)

As the last or, "clean-up" man on the Panel for the day, I have the uncomfortable feeling that everything that needs to be said has been said. So I shall try to avoid as much duplication as I can, particularly because, as a clean-up batter, I don't see anybody left on base.

FROM THE FLOOR: Raise your mike.

COMMISSIONER SMITH: Raise it a little bit? I guess it hasn't been raised since Andy Rouse stood up here!

(Laughter.)

First, just to go on record about an item that has been talked about before. The Ash Council's proposal for transferring the Holding Company Act to the Power Commission from the S.E.C. -- I agree with that. It is overdue. But there are probably few proposals that have less sex appeal than that, so I share somewhat the cynicism about its being adopted. And as an expendable Commissioner, I almost hate to see that Act go, for by far the most interesting adjudications we have had at the Commission in recent years have been under that Act. Nevertheless, it should appropriately go to the Power Commission.

The uniqueness of the Ash Report in regulatory literature, it strikes me, lies essentially in its nonlegal perspective. A number of problems and goals that have drawn lawyers' attention about the administrative process over the years are indeed barely mentioned in the Report. For the most part, the reasons that are given for the recommended changes do not sound in justice or substantive policy, but in managerial efficiency.

I think that is something that we, as lawyers interested in the administrative process, have to give a bit deeper account than we are inclined, at first blush, to do. I believe that the public generally, and people in the executive and even legislative branches of the government, are showing great impatience with the very slow course and fragmented policies that have been exhibited by administrative agencies -- and those are not entirely unrelated to the structures of the agencies themselves.

The Report's value, and something of its limitations in a number of respects, are related to this quality in it. It led to the Report's strong "executizing" thrust.

I do share something of Bill Cary's and others' view that it is the quality of the person in the job that really makes the difference. Present powers of reformation within the agency that a strong Chairman has are quite considerable, and many of the reforming objectives that one would hope to achieve are to a measurable extent achievable within the agency itself. But that depends upon a strong Chairman and Commissioners who are willing to proceed along that course with him.

Clearly, as has also been said, the Ash Report serves an invaluable purpose in setting the stage for re-examination of the structure of administrative agencies. I think that it was a very wise decision in the President's Office to publish it for public comment, and to provide us with an opportunity to suggest modifications and changes in some of the proposals.

I personally hope that reforms will result from it, although I think that the present recommendations should be significantly modified. While the bow may be made of strong "Ash", I hope the arrow that reaches the Congress will be made of a somewhat different alloy!

(Laughter.)

As noted on the Panel earlier, the Report did not focus on the substantive problems with which regulatory agencies are having to deal. Having said that, I was particularly happy to hear Peter Flanigan's reference in his luncheon talk to the assignment of the Council of Economic Advisers.

I don't think the Ash Commission intended any kind of an implication that all solutions to the problems of administrative agencies and the regulation of the industries with which they are concerned, can be provided by mere structural reform and the creation of a strong single Administrator. I trust that the Ash Council wasn't kidding itself about that. I don't think that you can really look at administrative structural reforms without some relation to the policy questions, the substantive questions, in each of these industries with which we are concerned.

That is a factor, substantive policy, that I think has to be worked into an administrative agency reform program.

I didn't find this in so many words in the Ash Report, but it was stated loud and clear in another important Administration document -- the 1970 Economic Report of the President, with its persistent theme of de-regulation, using

competition as a preferable and more effective alternative to regulation. The 1971 Economic Report, I believe, was focused in that vein on the transportation industry. But the 1970 Economic Report spoke about it more broadly. And I would like to quote just a part of it:

"The American experience with regulation, despite notable achievements, has had its disappointing aspects. Regulation has too often resulted in protection of the status quo. Entry is often blocked, prices are kept from falling, and the industry becomes inflexible and insensitive to new techniques and opportunities for progress. Competition can sometimes develop, outside the jurisdiction of a regulatory agency and make inroads on the regulated companies, threatening their profitability or even survival. In such cases, pressure is usually exerted to extend the regulatory umbrella to guard against this outside competition, so that the problems of regulation multiply and detract from the original purpose of preventing overpricing and unwanted side effects . . . .

"More reliance on economic incentives and market mechanisms in regulated industries would be a step forward . . . .

"Industries have been more progressive when the agencies have endeavored to confine regulation to a necessary minimum and have otherwise fostered competition . . . ."

I might add that not only have industries been more progressive, but administrative agencies have been more progressive, when competition has been permitted to carry the main burden.

I think that it bears repeated pointing out that structural change is not the only important approach to improving administrative agency performance. A substantive policy, for example, that promotes competition to the extent feasible, as an alternative to regulation, can improve administrative results by constantly being the test of regulatory actions which otherwise might become solely industry protective or agency protective.

Now this is something that the agency should bring itself to do, and that depends more on personnel in the agency than structure. If external prods are necessary,

such as the Justice Department's intervention or the appointive power then these should be used -- and they can be used within the existing framework.

I though it perhaps significant -- I though it a significant omission anyway -- that there was no comment in the Ash Report on the role of the Antitrust Division of the Justice Department vis-a-vis regulatory agencies. That, I think, has been a significant development over the last five years, in terms of regulatory agency practice, which has affected not only the S.E.C., but the F.P.C. and some of the other agencies, where the Justice Department has put the test of alternatives to the substantive regulatory policies those agencies had heretofore been following.

I believe that it is fair to say that the two most troublesome functions in the administrative regulation of business, both in terms of procedural treatment and in terms of the effect on agency quality and agency independence, have been the license-granting and rate-making functions. These are the regulatory alternatives to competition in entry and competition in pricing, and they oftentimes tend to bring out the worst in agency performance.. Neither of

the two functions were generally thought to be present at the S.E.C., which looked upon itself as primarily a disclosure agency.

The S.E.C. has no franchises to grant. We do register broker-dealers, but it is a kind of pre-entry qualification method subject to rather minimal financial and educational standards. It is not licensing in the sense of issuance of a certificate of public convenience and necessity that excludes or limits competitors.

Well, we haven't had that licensing function, and until the last several years, at least, the Commission was not required to get deeply involved in regulation of stock exchange brokerage commissions. This absence, or believed absence, of both the licensing and the rate-making functions has had, I believe, a great deal to do with the superior performance of the S.E.C. The Ash Council called it "one of the ablest" of the agencies. Frankly, I would have some concern for the result on the S.E.C. if it were now to assume a major rate-making function, as it necessarily must to the extent that brokerage commission rates or other pricing activities remain fixed.

For that reason, among others, I for one -- now that we are conscious of our rate-making responsibility -- would like to see our agency systematically get out of the rate-making business to the extent warranted. And as you know, we have taken an initial step toward competitive commission rates -- the only way that we can get out of the rate-making business.

Now both the license-granting and the rate-making functions were, for the most part, conceived in this country to be legislative in nature, although I suppose some rate-making did occur in the courts before the era of the administrative agency.

The one-man agency responsible to the Executive Branch recommended by the Ash Report, of course, is a complete shift -- as Steve Ailes pointed out -- from the historical origins and from the concept of an administrative agency that is an arm of Congress. Well, that alone doesn't make it bad. But it does indicate the dimension of change to which the recommendations take us.

The earlier concerns to regularize the process of granting franchises and setting rates and the other functions that the administrative agencies perform, the "judicializing" of agency processes, were really to protect the government

and the agencies against the abuse of these enormous powers, against, for example, ex parte communications such as Lee White described earlier this morning. Those procedural safeguards did introduce a rigidity in the system, but I am not persuaded it is desirable to completely overturn them as some Ash Report statements tend to imply.

It may well be that, to some extent, judicializing the administrative process has been carried too far, and has really become a device not to protect the government from abuse but to protect regulated companies or to protect an agency from having to reach decisions.

My own view is that the Ash Report recommendations -- at least as they regard the Securities and Exchange Commission -- go too far in one respect, and not far enough in another.

The single administrator concept -- despite the fact that it would "expend" me -- has to me a great deal of appeal. In the administration of the agency, we almost have that now. The chairman is appointed at the pleasure, and remains in office at the pleasure, of the President, and he had complete control over staff. And so, at least in the administration sense, the centralization of administrative

responsibility is already significantly in effect. There are certain things under the Reorganization Bill over which the chairman does not have exclusive power, such as the budget. I myself would like to see that and similar matters go into the hands of the chairman totally.

Now with respect to rule-making functions, I have a little more trouble there, for two reasons. While I said I am attracted to the one-administrator idea, I myself would like to see that modified to a three-man Commission, and it is because of my concerns in the rule-making area that I would do that.

For one thing, the delegations of legislative powers from the Congress have tended, I believe, to be broader to the independent regulatory agencies than to those that are in the Executive Department. That may be too much of an over-generalization, but I do think it is fair to say that the delegations to the administrative agencies have been in broad terms of public interest, leaving to the agencies the development of the standards of that public interest and their application to changing conditions in the industries that are regulated. This ability to make rules within such vague statutory language is an extremely broad power that I wouldn't feel comfortable giving to one man.

I know, in my own case -- and I suppose that it is something of a natural reaction for many people who at least try to think for themselves -- I had the experience of serving with a very activist, strong-minded Chairman, and my instinct was to lean against that somewhat, to be more conservative in my views. I think that that probably was a good thing in the deliberations of the agency at that point in time. And with a Chairman who felt less activist, I tended to lean in the other direction. I suppose that is somewhat of a natural instinct, and I can't help but think that that kind of interaction is a good thing.

As a practical matter, I doubt that the Congress would buy a single administrator, whereas by reducing the size of an agency to three, bipartisanship could be preserved, which I think on balance is a good thing. To have three men engaging in this deliberative process of rule-making seems to me preferable to one.

Now one might question why three. Five, seven; eleven? I would go to three simply because that is the smallest odd number above one, and there undoubtedly are greater efficiencies in smaller numbers. I do expect that there is some advantage, given the administrative burdens, to having a smaller group. It is a question of balance. Five can become a somewhat cumbersome number and seven and eleven, I guess, most everyone recognizes as being impossible.

Shifting to adjudicatory functions, to the extent they are left within the agency they are clearly in trouble with a single administrator. (To put one relatively minor point aside, I understand that Andy Rouse agrees that a thirty-day appeal period from an examiner's decision is unrealistic.)

The traditional concerns about separation of functions that Louis Hector has spoken to so eloquently in the past, of course, are not solved in the least by the administrative court proposals of the Ash Council. And that is the area where I feel that the Ash Report recommendations don't go far enough. The Ash Report leaves initial adjudication in the agencies and makes the administrative court a purely appellate function. I would like to see the hearing function -- at least in certain types of matters -- given to the administrative court as well.

Here I think it is important to recognize that agencies are different. Although the Administrative Procedure Act categorizes rate-making as rule-making and licensing as adjudication, there is something forced about fitting these unique administrative processes into that traditional separation of function. Clearly franchising and rate-making should remain with an agency charged with those functions, and by advocating the splitting out of adjudication from the agencies, I am to some extent redefining adjudication for that purpose. I would keep licensing in those agencies that do that, and not put it in an administrative court except for appellate review purposes. I can see insurmountable problems, for instance, above moving route awards by the transportation agencies, which are presently called adjudications, into such a court.

The Securities and Exchange Commission has a lot of adjudication that is not of that uniquely administrative agency quality. The F.T.C., I would imagine, would be the closest to us in the type of case best performed by separated adjudication. Many of our cases involving broker-dealers are, essentially, decisions of a traditional judicial nature, involving determinations of fraud and fiduciary standards, and applying fraud and fiduciary concepts to the complexities of the modern financial markets.

Bill Cary talked about the Cady, Roberts experience, which is a very impressive one. But I don't think that it argues quite the way he sees it. I know that our distinguished General Counsel, Phil Loomis, agrees with Bill and feels that Cady, Roberts is an example of why one should not split adjudication out of our agency.

And Phil cites another example -- the boiler room cases, which in some ways are even more dramatic. As I understand it -- this was before my tenure -- the Commission was very much concerned about the practices of boiler rooms. Back in the late fifties there was a lot of high pressure, misleading selling of worthless securities by organized telephone campaigns, and the first instinct of the Commission then was to draft rules that would prohibit this. The rule drafting went on for an extended period of time. And in the end it met with a lack of success because the techniques of the boiler room were so varied. The minute a rule was drafted with some specificity, one would see some way for somebody to get around it or raise due process objections to it. It is very difficult to employ rule-making in the fraud area generally, because every time you draw a line, there is a way to swing around it. And so, in the end, a series of adjudications were started against the boiler rooms, and out of that grew administrative decisions that were successful with precedential value in curbing those practices.

I believe that I understand what Bill Cary and Phil Loomis are saying in this respect, and they point in addition to the way in which Cady, Roberts was the precursor of Texas Gulf, was cited in Texas Gulf, and so on. But I am not sure that the same result could not have been achieved by the Commission initially bringing injunctive actions in the district courts as was done in Texas Gulf, and arguing in the courts for expanding the definition of fraud. Certainly, Judge Friendly and the Second Circuit had no difficulty in seeing the justice of the Commission's cause. I have enough confidence that cases, particularly in these areas, could be made persuasive enough that there is no need really to keep them within the agency.

One of the most difficult problems that I have personally had as a Commissioner is in giving the amount of time to adjudication that perhaps my idealized view of what a judge should do leads me to desire. Given the other pressing, difficult matters that we have had at the Commission over the last two or three years, I am troubled by the amount of time that I can actually spend looking at the record and deliberating on matters that come up to us on adjudication. As good as our record-review and opinion-writing group is, the institutional decision is hardly satisfying either to the adjudicator or the adjudicated.

There are so many hours in a day. You have to make choices. I agree with the Ash Commission's thrust, that the most important things the administrative agencies have to do -- certainly that ours has to do -- is to look at industry-wide problems, get increased input from economic analysis into our work, and try to get our policy approaches into some sort of anticipatory stance to problems. It is difficult to do that, given the time lag, in adjudications. Many of the problems with which we have to deal really can't be solved with traditional adjudicatory approaches. So - for our agency at least - I would like to see adjudication (as I would redefine it) moved out completely.

But moved to a very expert administrative court, which would have a securities panel on it of, say, three judges expert in that substantive area, to which the Commission could bring its cases. There is no reason why a Bill Cary or Henry Friendly couldn't be sitting on such a court, so that we could get sophisticated interpretations of our law that meet the problems with which the Commission is dealing. To make it a more appealing judicial position, there could be an ability on the part of a judge of the court to sit on its various panels.

With the expansive evidentiary rules available in an administrative court, I think that policy considerations, and the expertise that the agency developed in administrative regulation, could be well communicated to that court in one fashion or another.

When I came to the SEC almost four years ago, I had some doubts about the realities of separation of functions. I think my doubts have since been largely resolved. I greatly admire the integrity with which the separation is actually observed within our agency, so I don't have concerns of that kind anymore.

But there is something nagging about hearing of a case on a request for an order of investigation, and you issue the order. Then it comes back to you for an order instituting proceedings, and again you hear something about the case from the staff. Then it may come to you on an offer of settlement, and finally it comes back to you as often as a fourth time on appeal from an examiner's decision when you do your best to act as judge. I would think it preferable, when you are dealing with people's rights to do business, that they be judged in a separate forum.

It is implied in what I have said that our hearing examiners should be moved to such a court. The court could make flexible use of the hearing examiners. By reason of its exposure to adjudications brought to it by various agencies, it would have a better perspective on administrative adjudicatory procedures that could spur their needed improvement. Some difficulties of the administrative process do exist at the hearing level. I would like to see an expert administrative court have

more direct responsibility for, and control of, the conduct of hearings and the assignment and advancement of hearing officers.

If there were such a separate administrative court, I would think its sanction power might be expanded beyond what our agency presently has, to include for example power to order restitution and issue injunctions.

So, in the end, I come out somewhere between the extremes. I have suggested that structural reform cannot substitute for excellence of personnel or vigor of substantive policy, but agree that some structural reform to achieve these goals is desirable. On that I would urge the Ash Council to go steps beyond where they are on the administrative court, and to draw back to some degree from one administrator.

Thank you.

(Applause.)