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# WHEN DOES COMPETITION IMPROVE REGULATION?

*Honorable Frank H. Easterbrook**

When Bill Carney asked me to give the keynote address for this symposium on the interaction between regulation and competition, I was taken aback. I am, after all, one of the critters under study. You should watch the rats run their mazes, not ask them to describe or analyze the experience.

Yes, I must confess: I'm a regulator. Judges are the regulators with the broadest portfolios, and thus are the least competent. I hope this does not extend to competence at giving talks! Also, you'll note that I'm speaking from notes. This is because federal officials must take all possible steps to avoid saying anything interesting. At this, I hope, you'll agree that I have the skills to succeed. Seriously, judges do have to steer clear of pending litigation, so some of the juicy tidbits about Enron and the like are off limits to me—though not to the other speakers. Still, I hope to have a few words to say about the sort of issues to which they gave rise.

One proposition commonly heard in the public press, and sometimes in the scholarly press, is that competition among issuers and accountants has led a race to the bottom, as both try to deceive the public. The deceivers seem to have short time horizons and to be insensible to the pain they receive when caught. Why should they have overlooked their self interests so completely? No *large* fraud stays hidden forever—especially not when the fraud consists in projecting a twenty percent annual growth rate, a process that (if continued) implies that the whole world economy will be smaller than a single firm. The disparity is *bound* to be noticed eventually!

But, in the common story, if issuers and accountants and investors are too dumb to understand these things, wise regulators must step in to protect the parties from themselves. Hence we see the Sarbanes-Oxley Act with its new board to review performance of the accounting profession, its requirement of separation between accountants and consultants, and so on. From the

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perspective underlying this legislation, greater competition among issuers (and across borders, for the world of finance is global and fiercely competitive) had led to greater fraud; and growth in fraud sparks growth in regulation to protect the rest of us. Competition thus breeds regulation.

Sarbanes-Oxley is only one among many recent regulatory interventions. The SEC has proposed requiring executives to reveal their stock sales faster, the better to curtail insiders' trading. Congress has revised the rules under ERISA to allow new options in pension plans so that participants can sell securities without the same blackout periods formerly employed. But by using the word "options" I do not mean derivative securities, or even the lay sense of new opportunities—for these laws restrict the scope of private contract. "Options" in regulatory lingo means *mandatory* terms; the choice set is not increased. One wonders why competition has not produced these terms if they were *really* beneficial for investors. Each of the new requirements is costly, and as there is no such thing as a free lunch someone must pay those costs. In competition the "someone" will be the employees; "better" terms will come at the expense of lower benefit levels, and some (perhaps many) of the employees will find that this compulsory exchange has made them worse off.

Striking events always have legal consequences. Congress also passed a bill regulating contributions and expenditures in the electoral process—even though Enron didn't *get* anything for its money. Congress has federalized the airport screeners—as if we admired the Postal Service so much that we are determined to extend the domain of socialized production. Yet errors by airport screeners had nothing to do with the terrorists' access to airplanes. Rules in force on September 11, 2001, *allowed* passengers to have box cutters, and al Qaeda was careful to buy round trip tickets with credit cards so as not to trip any automated alert systems. Screeners did exactly what they had been called on to do; how does this justify change? But perceptions of crisis breed regulation, in the world of securities and the world of transportation alike, by reducing the public's perceived cost of regulation and increasing the appearance of benefits. This makes enactment of regulation easier by mollifying the opposition, or even turning those who will bear net costs of regulation into enthusiasts for it.

What gets adopted are not laws newly devised for newly discovered facts, but drafts long in process and brought to the fore by happenstance. The enormous USA PATRIOT Act was not written in a fortnight; it was cobbled together from proposals made, and rejected, in the past. Much the same is true of the Homeland Security legislation and Sarbanes-Oxley. In each case, I suspect, private interest groups or established bureaucracies are not only the major proponents but also the principal beneficiaries. For example, we may have federal screeners because the screeners themselves wanted it, and this was a perfect time to capitalize. Federal employees are hard to discharge or even to discipline. The screeners get extra job security plus higher wages, a great combination. The traveling public gets higher prices but limited protection. Israel's head of transportation security has quipped that the United States does not have a system for protecting air travelers; it has instead a system for annoying air travelers. This is the story of regulation—a concentrated interest group obtains a benefit, with costs widely dispersed among people who are not in a good position to fight back. But over time these costs will grate, and airports may use their option to privatize again in eighteen months' time.

This point can be generalized. Mancur Olson has done this nicely,[1] and several participants at this symposium have used and extended his work. On this understanding, itself an extension of Madison's Federalist No. 10, most regulation—other than rules against theft, fraud, and monopoly (to generalize, rules that deal with third-party effects)—has more to do with rent seeking than with consumers' benefit.[2] Regulation is a means by which a segment of the populace enriches itself at the expense of the general welfare. How much that segment can get away with depends on relative costs—and although perceptions of costs may change with today's crisis, hence federal screeners, new accounting-oversight boards, and a mandatory separation between accounting and consulting—long-run costs do not change. Enron is not the first financial fraud and won't be the last. Remember OPM or Equity Funding?[3] Thus Enron-related events are unlikely to have lasting effects. In the long run investors gain from the least-cost solutions, and laws that remove options from the choice set cannot supply these. Other jurisdictions could, however; the

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1 *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1965); *see also, e.g.*, JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT (1962); GEORGE J. STIGLER, THE CITIZEN AND THE STATE 103-41 (1975); Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974).

2 *See generally* Frank H. Easterbrook, *The State of Madison's Vision of the State: A Public Choice Perspective*, 107 HARV. L. REV. 1328 (1994).

3 After the Equity Funding scandal came to light, the SEC attempted to shoot the messenger. *See* Dirks v. SEC, 463 U.S. 646 (1983).

international finance market is highly competitive. And *that* competition will undermine crisis-based reactions in the United States.

As today's speakers well know, regulation depends on political support. When asking whether a person or group exercises political influence disproportionate to its numbers, and thus can get regulation, the first question is: how does this group solve the problem of free riding? People who *could* influence legislators, if they tried, need a good reason to try. If other persons similarly situated will do the job, any particular member of the group can sit on the sidelines, reaping the benefits without incurring the costs. As the group grows in size, free riding becomes first serious and then intractable—unless a solution can be found. Overcoming free riding is easier when the group is small, cohesive (ideally, when dropouts are impossible), able to target large benefits on each member and to exclude non-members from sharing in these benefits, and able to spread the costs widely so that they do not stir up opposition. Your group prevails if its free riding problem is less serious than the problem afflicting your rivals. In many ways the *most* powerful groups are those that the conventional wisdom treats as powerless: for example, minorities that have limited agendas, and from which dropping out is not an option, and dairy farmers who are small in number and whose upbringing and way of life make dropping out of the group very costly.

How do corporations fare in handling free riding? Poorly. Corporations do not vote and are forbidden by law from making political contributions. Thus corporate influence depends on firms' ability to engage the interests of investors and other stakeholders. Yet there are many large firms, with constant entry and exit. Large corporations have widely traded investments. Liquid securities markets make buying and selling these investments easy. Dropout at the investor level is almost costless. Portfolio theory has taught investors, and their surrogates at pension and mutual funds, that safety lies in diversification. A diversified investor cares about the success of the economy as a whole and is indifferent to the fortunes of any corporation. Rational ignorance prevails. Most investments today are held in diversified portfolios, and indirectly (by insurance or pension trusts or university endowments) rather than by natural persons. So real people, who alone have the power to vote, do not much care what happens to particular firms. They are protected not by personal diligence but by competition—and competition may enable them to evade regulation even if one part of the economy (or one nation) imposes it.

Where the biggest regulatory effects prevail is thus likely to remain agriculture. U.S. farm programs cause the price of sugar in this country to be *double* the world price, and things may get worse. Brach's recently announced that it will close its flagship Chicago plant as a result; it can't afford the domestic price of candy's largest ingredient and will move production (and 1100 jobs) to Mexico, where the world price prevails. But the losers—a few thousand jobs, and consumers who must pony up a few cents per chocolate bar—are scattered. The gains are concentrated. The forces out to defeat markets have the upper hand.

Let me ask now whether this is true in pensions, financial markets, energy, telecom, or other current news bites.

I don't see how any number of scandals or frauds can change the long-run level of regulation in financial markets. Regulation of securities markets has been diminishing steadily since the mid-1970s. Registration has been made simpler; private offerings (which require no disclosure) may be made to any number of sophisticated investors. The causes are several. It is easier to invest abroad (this means U.S. money in Europe or Asia, as well as foreign money in the United States). As it is easy to move funds across national borders in a world of floating exchange rates—and easy to protect against exchange-rate risk in a world of currency-futures contracts—no one country can impose costs on investors. Any attempt to do so will induce firms and investors to transfer funds elsewhere. What makes this cheap is that only the money moves. U.S. firms can raise funds for U.S.-based projects in London; German firms can raise money in New York. Not only securities controls but also quirky accounting rules are avoided in the process.

Another source of pressure is competition among financial instruments. The SEC can't impose expensive controls on issuing securities these days, because people will trade derivatives in Chicago and get the same risk-return combination. And Congress can't slap controls on derivatives because *they* can be traded anywhere. The Commodity Futures Modernization Act of 2000 reduces regulation on over-the-counter swaps products, opens professional markets in exchange-traded derivatives, and allows single-stock futures trading. This was not done because the New York securities markets and professionals were generous, or because the SEC willingly gave up its regulatory domain, but because the flight of this business from the United States left no alternative; it was deregulate or die. When people can move freely to unregulated financial derivatives that give them the same risk and return combinations as regulated securities, there is little real leverage for any securities regulator. Nothing about current scandals changes that equation.

Now it is true, as Jon Macey emphasizes,[4] that regulators may respond to competition (and the free movement of capital) by agreeing among themselves to restrict it. I wonder, however, whether they can succeed. The history of financial regulation in U.S. markets suggests that they cannot—that unless interest groups join forces with regulators, the officials themselves can't suppress competition, and that when competition makes it unprofitable to demand regulation, these interest groups will pull the plug on both the regulation and the regulators.

For a long time after the Great Depression, the United States separated commercial banking from investment banking, through the Glass-Steagall Act. But this was unstable because, as international competition grew, U.S. entities had to face rivals that did not suffer from the costs of this separation. Moreover, the Federal Reserve permitted holding company structures that evaded these restrictions, and the development of new derivative securities allowed each of the supposedly separated entitles to transact business that was functionally identical to the other's. The SEC tried to get together with the Fed to stop this, but the Fed (with the support of its own clients) would not cooperate. As the costs of Glass-Steagall rose and its effectiveness fell, it lost political support and was repealed. One of the steps in the decline of political support was that both commercial banks and investment banks went public. For reasons I have explained, this cost them dearly in the ability to wield political influence and keep the barriers that protected them from competition. This is one public benefit of "going public" that Berle and Means never understood![5]

Now consider the regulation of securities and futures contracts. In 1920 and 1933, when separate futures and securities regulators were created, trade in wheat contracts and pork bellies, the domain of what is today known as the CFTC, looked very different from trade in corporate debt and equity, the domain of the SEC. True, some options were traded on stock exchanges, but these posed no threat to the futures exchanges. The development of the Black-Scholes options-pricing formula, however, made it possible in principle to

[4] Jonathan R. Macey, *Regulatory Globalization as a Response to Regulatory Competition*, 52 EMORY L.J. 1353 (2003).

[5] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev. ed. 1968).

create derivative securities that would mimic the risk and return of the primary instruments—and these new derivatives could be traded as futures contracts in Chicago or swaps over the counter at Bankers Trust. Futures trading in both public and over-the-counter (OTC) markets can be conducted anywhere in the world, thanks to geosynchronous satellites that move order flow and price information, instantaneously and essentially costlessly, to every part of the globe. Competition became pervasive.

The SEC wanted to protect its turf—and by "its" turf I mean not only that of the bureaucrats but also, more importantly, of the agency's principal clients, the stock exchanges. But the CFTC and its clients preferred to fight rather than switch, because they knew that a regulatory cartel (or a business cartel supported by regulation) would drive business abroad rather than divert it to the stock exchange in New York. So regulatory competition tracked the business competition. The banks and the Treasury Department got into the fray, securing the enactment of a proviso that excluded currency futures and OTC swaps from most regulation.[6] But once there was free competition in OTC swaps, which are single-firm custom-made derivative instruments, it became impossible to maintain for professional hedgers and arbitrageurs most of the regulatory apparatus in futures markets. It was too costly.

The SEC tried to do this anyway, taking advantage of a statutory provision that had been designed to protect the turf of stock exchanges from single-stock futures contracts (which would be good substitutes for stock options). Its effort to ban trading in index futures on the Dow Jones utilities and transportation indexes was rebuffed in court.[7] This left only two real options for the regulators and interest groups: either shut down all competition between derivatives and the products on which they are based, or embrace that competition and allow all markets access to all products. The former was implausible because of competition from abroad. Money is fungible and instantly movable; even elaborate international regulatory agreements could not stop OTC swaps of derivatives and advanced products (such as long-term energy contracts) whose pricing has derivative components.[8] So there was nothing to do but open the doors. This the 2000 legislation did: it permits professional markets where anything goes, permits single-stock futures

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[6] *See* Dunn v. Commodity Futures Trading Comm'n, 519 U.S. 465 (1997).

[7] *See* Chi. Bd. of Trade v. SEC, 187 F.3d 713 (7th Cir. 1999); *see also* Chi. Mercantile Exch. v. SEC, 883 F.2d 537, *reh'g denied*, 883 F.2d 550 (7th Cir. 1989). These two opinions discuss much of the history.

[8] Indeed, corporations can themselves be set up as forms of derivatives. *See generally* Frank H. Easterbrook, *Derivative Securities and Corporate Governance*, 69 U. CHI. L. REV. 733 (2002).

contracts, effectively deregulates the stock exchanges themselves (for the professional markets are free competition to them), and otherwise opens the door to new financial devices, strategies, and institutions.

In the longer run this competition is bound to have effects on the rules for issuing securities and auditing firms. When the participants in markets internalize all of the costs, there is little point in regulation—it isn't needed to protect anyone (contract and fraud law will do that) and won't increase anyone's profits, so no interest group will support it.[9] This proposition has led some scholars, including George Stigler and George Benston, to wonder whether there is *any* point to regulation of what corporations disclose to investors, or the way in which corporations keep their books.[10] Some years back, Dan Fischel and I suggested that perhaps there is an externality after all: the value of stock in Firm A depends not only on what A is doing, but also on what its competitors B, C, and D are doing.[11] Firm A would like to disclose optimally in order to assure investors and attract capital on the most favorable terms (that is, with the least possible compensation for firm-specific risk that investors must be paid to bear),[12] but it can't do this without correlative disclosures from B, C, and D. These rivals would prefer, however, to keep secrets in order to obtain advantages in the markets for their products. A system of mandatory *and reciprocal* disclosure might overcome that third-party effect; each issuer loses some advantage in the product market, but all gain an advantage and cost reduction in capital markets.

That rationale for mandatory disclosure supposes that everyone is a player. Yet that is no longer true—if it ever was. The growth of private-offering exemptions for sales to sophisticated investors enables large U.S. firms to raise the bulk of their capital without public disclosures. The growth of international finance allows issuers to raise money under other legal systems—not only by

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9 *See* Frank H. Easterbrook, *Monopoly, Manipulation, and the Regulation of Futures Markets*, 59 J. BUS. S103 (1986).

10 George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973); George J. Stigler, *Public Regulation of the Securities Market*, 37 J. BUS. 117 (1964), *revised and reprinted* in STIGLER, *supra* note 1, at 78; *see also* Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J.L. & ECON. 613 (1981); Carol J. Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295 (1989).

11 *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, 276-314 (1991) (drawing in this regard on a paper published in 1984).

12 On which see Michael Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976), and Henry G. Manne, *A Free Market Model of a Large Corporation System*, 52 EMORY L.J. 1381 (2003).

direct foreign issue, but through devices such as American Depository Receipts (ADRs) in the United States. Again reciprocity is broken. And the availability of derivative securities, which are not accompanied by disclosures because they do not come from "issuers," further breaks the link between investment and disclosure. For all of these reasons the goal of a mandatory-disclosure system is harder to achieve; and as the benefits of a system fall, one expects it to wither unless large interest groups sustain it.

Who might those groups be in a world of put-call parity and international money movement? Investment banks are one possibility, but competition from derivatives makes investment banks less profitable. The goal of curtailing competition from different investment banks and exchanges, so prominent in the 1933 and 1934 Acts, is no longer achievable.

Accountants are another potential support group. I suspect that the major firms are moving forces behind Sarbanes-Oxley. Accounting firms have *not* gone public; they serve as more concentrated interest groups and should be able to wield great clout. The largest firms likely see the legislation as a way to curtail liability risks and, more important, to preclude competition from other accountants. If a uniform set of rules and business practices is legally required, one major source of competition has been shut off. But this will not better protect investors—who are automatically protected by competition (they always get the going rate of return on investment) and diversification. It will instead slightly reduce issuers' profitability, as accountants get a somewhat larger slice of the pie. Carving off the consulting business costs little, if all rivals must do the same (and recall that Andersen had spun off its consulting arm, as Accenture, earlier); there may be an efficiency loss, but this is passed on to investors and not felt by accountants.

Much the same can be said about electricity. What has led to deregulation is a reduction in the cost of moving energy over distance, coupled with an increase in the cost of siting plants close to the retail-distribution networks in big cities. These combine to eliminate any natural monopoly in pairing generation with distribution. A state such as California that wants to be clean locally, but not to have nuclear power, has no choice but to import power from plants situated in less populated areas.

We learn from its experience that *faux* deregulation is a bad thing. California did not allow the market to work. It *prohibited* long-term contracts or other devices to hedge the risk of price increases. Apparently the local legislature thought that prices would fall eternally, so that the spot market always would be better than term contracts. Likewise California capped the price of power sales while allowing wholesale prices to fluctuate; this enabled Enron to *buy* power at the capped price and sell it back to California at the uncapped price. The process was absurd, but this opportunity for abuse was *created* by meddlesome regulations. Whether California has learned from its experience I do not know; but the cost of regulation has become a little clearer, so it will be harder for interest groups to maintain the system. Other countries, such as Australia, have done better by going whole hog. This implies that the costs borne by consumers from regulation are high, which means that interest groups will be able to buy less regulation in the long run.

Lest I be accused of uncritical enthusiasm for every variety of competition, let me look briefly at a potential dark corner—which just happens to be in antitrust, the other subject of this symposium. We think of antitrust as a means to promote competition, and so it is—when it is *producers* that are competing. There is another kind of competition—competition among plaintiffs to get the spoils of victory.

In the United States, suits may be filed by the Department of Justice, the Federal Trade Commission, fifty-four state and territorial governments, and about 300 million private citizens—including corporations, which may see antitrust as a great means to squelch their rivals. In other words, although litigation *should* be designed to end practices that curtail output and drive up prices, often it is an exercise in rent-seeking and is directed against practices that *raise* output and *lower* prices. It cannot have escaped attention that the principal plaintiffs in the ongoing cases against Microsoft are its competitors, such as Sun, and the attorneys general of the states in which the competitors have their headquarters. This is a common constellation. Normally competition among jurisdictions serves the ends of consumers,[13] but competition to impose costs on citizens of other states is an unpleasant side effect in need of control.

Courts are not supposed to go along with suits by or in the interest of rivals,[14] but error is endemic in the judicial system. Let us suppose that there is a ten percent chance of a Type I error—that is, wrongful condemnation of an efficient practice—in any given antitrust case. If ten cases can be brought in

[13] *See generally* Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23 (1983).

[14] *See* Atl. Richfield Co. v. USA Petroleum Co., 495 U.S. 328 (1990); Cargill, Inc. v. Monfort of Colo., Inc., 479 U.S. 104 (1986); Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477 (1977).

different jurisdictions, and they are resolved independently, then the risk of wrongful condemnation in at least one case climbs to sixty-five percent ($0.9^{10} = 0.349$). Because any federal judge can issue a nationwide injunction, a single false positive can obliterate the challenged practice. And if the risk of a Type I error is fifteen percent, then the aggregate error rate in ten suits is eighty-one percent—which is to say that efficient, pro-consumer practices are highly likely to be suppressed. These numbers should cause great discomfort—and some large firms, of which Microsoft is only one example, are facing more than ten independent suits about the same practices. Maybe judges do better than this example gives them credit for: if the rate of Type I errors is five percent, then ten suits produce "only" a forty percent risk of wrongful condemnation. Sorry, but I'm still worried. Not until the error rate gets down to the one percent range in any given area does my concern abate—and I must tell you that the judges I know err more often than that. I do too.

In other nations, private suits either are disallowed or are hedged about by controls that curtail these risks. One sort of control is eliminating the "independence" assumption of my example. That is, all suits are consolidated in a single trade court, so there is only one effective decision no matter how many suits are filed. Another form of control could be to disallow suits by competitors and state officials seeking injunctions; then errors could not have nationwide effects, and the risk of error would not cumulate as it did in my examples.[15] Still, business rivals might sponsor suits by consumers, so this control might not be effective. (This is also why the antitrust-injury doctrine is only a limited source of protection from rent-seeking through antitrust.)

Still another approach is safe harbors. The federal regulatory agencies could be empowered to immunize practices from private antitrust challenges. This creates an opposite risk of rent-seeking: businesses could seek protection for their anticompetitive practices. Think of the stock market until 1975: a cartel with the legal support (indeed, supervision and compulsion) of the SEC.[16] Still, this seems to me less worrisome than the current system because, as I have emphasized, public corporations are not very good at obtaining political favors. But a different variation on this proposal would be to break the independence assumption by treating the first judicial decision as definitive

[15] *See* RICHARD A. POSNER, ANTITRUST LAW 281–82 (2d ed. 2001).

[16] *See* Gordon v. N.Y. Stock Exch., Inc., 422 U.S. 659 (1975); Thill Sec. Corp. v. N.Y. Stock Exch., 433 F.2d 264 (7th Cir. 1970); and the 1975 amendment to § 19 of the Securities Exchange Act of 1934, 15 U.S.C. § 78s, that finally ended federal support of the cartel.

nationwide. This would effectively force all plaintiffs into a single forum—where error still might occur, but where the risks of error would not be additive.

Let me return to my main theme, which I developed for securities law: Talking heads on TV and editorial page writers can natter all they want, but there is a (political) market in regulation as there is a market in other things, and the amount of regulation we have will depend on the long-term prices in the political and economic markets. Competition will depress price, with consequences for regulation. Exceptions of the kind I gave in antitrust are rare and depend on the role of government—for the Type I errors are governmental mistakes. Left to its own devices, competition is a wonderful balm.